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IN THE

Supreme Court of the United States

October Term, 1961

AARON M. NADLER,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent,

SECURITIES CORPORATION GENERAL,

Intervenor,

DYNAMICS CORPORATION OF AMERICA,

Intervenor.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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INDEX

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
The Statute Involved	3
Statement of the Case	4
Reasons for Granting the Writ	10
Argument	12
Conclusion	24
Appendices	
A. Decree and Opinions Below	25
B. The Statute	58

Citations

Cases:

Brouk v. *Managed Funds Inc.*, 286 F. 2d 901 (8 Cir., 1961) cert. granted 366 U. S. 958 ..... 11, 21

Brown v. *Bullock*, 294 F. 2d 415 (2 Cir., 1961) 11, 22

Goldstein v. *Groesbeck*, 142 F. 2d 422 (2 Cir., 1944) cert. denied 323 U. S. 737 ..... 20, 22

Haggar Co. v. *Helvering*, 308 U. S. 389, 394 17

Nadler v. *Securities and Exchange Commission*, 296 F. 2d 63 (2 Cir., 1961) 2

PAGE

Texas & Pacific Railway Company v. Rigsby, 241 U. S. 33, 39-40 18

Westerlund v. Black Bear Mining Co., 203 Fed. 599, 611, 613 (8 Cir., 1913) 18

Statutes:

All Writs Act, 28 U. S. C. §1651 9

Investment Company Act of 1940, 15 U. S. C. §80a-1—§80a-52

Section 1(b), 15 U. S. C. §80a- 1(b) 3, 17, 18

Section 16(a), 15 U. S. C. §80a-16(a) ..... 2 and Generally

Section 17(a), 15 U. S. C. §80a-17(a) 3, 23

Section 17(b), 15 U. S. C. §80a-17(b) 3

Section 23(c), 15 U. S. C. §80a-23(c) 3, 23

Section 43(a), 15 U. S. C. §80a-42(a) 2, 3, 7, 9

Section 44, 15 U. S. C. §80a-43 ..... 3, 8, 19, 20

Section 47(b), 15 U. S. C. §80a-46(b) 2, 3, 7, 19, 23

Judiciary and Judicial Procedure Act, 28 U. S. C. 1254(1) 2

New York Banking Law §118, McKinney's Consolidated Laws of New York Annotated, Vol. 4, Part 1, page 258 14

Public Utility Holding Company Act of 1935, 15 U. S. C. §79-79z 22

Miscellaneous:

SEC Report on Investment Trusts and Investment Companies (1940), Part 3, Chap. IV, p. 1017 et seq. and p. 1877 et seq. 12

Ibid, footnote 27, page 1029 14

Washington University Law Quarterly, Vol. XXVI —pp. 323-324 (1941) 14

50 *Yale Law Journal*, 440, 447 14

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Your petitioner, Aaron M. Nadler, respectfully prays that a writ of certiorari be issued to review the decree of the United States Court of Appeals for the Second Circuit, entered in the above entitled case on November 14, 1961.

Opinions Below

The opinion of the Court of Appeals (App. A, *infra*, pp. 27 to 30) is reported at 286 F. 2d 63 (2 Cir., 1961).

The findings and opinion of the Securities and Exchange Commission dated December 23, 1960 (Investment Company Act Release No. 3105) are unreported and are printed in App. A, *infra*, pp. 32 to 50.

The order of the Securities and Exchange Commission dated December 30, 1959 (Investment Company Act Release No. 2958) is unreported and is printed in App. A, *infra*, pp. 51 to 57.

Jurisdiction

The Decree of the Court of Appeals was entered on November 14, 1961 (App. A, *infra*, p. 25).

The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1) and under 15 U. S. C. 80a-42(a).

Questions Presented

1. Can persons prohibited from serving as directors by Section 16(a) of the Investment Company Act of 1940 sell the major asset of a registered investment company to those who placed them in control, and partially liquidate the company?

2. Are the acts of the illegal board of directors in carrying out and consummating such a transaction void or voidable at the election of a public stockholder of a registered investment company under Sections 16(a) and 47(b) of the Act?

3. Does a public stockholder of a registered investment company have the right to bring an action in the courts under Section 44 of the Act to rescind the acts and transactions which he has elected to void?

4. Does Section 44 of the Act confer exclusive jurisdiction upon the courts to try violations of the Act and to enforce any liability or duty created thereby?

5. Is a determination by the Securities and Exchange Commission not to seek enforcement of a violation of Section 16(a) of the Act, or that no violation exists, binding upon a public stockholder of the registered investment company or the courts?

6. Is a violation of Section 16(a) of the Act excused by ignorance of the law, can it be cured by the subsequent ratification by the violators of their own illegal acts, and is proof of actual fraud, in addition to the violation of the statute, necessary for its enforcement?

7. Whether the foregoing are not questions of law for independent judicial determination by the courts?

The Statute Involved

The statutory provisions involved are Sections 1(b), 16(a), 17(a), 17(b), 23(c), 43(a), 44, and 47(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-1(b); 80a-16(a); 80a-17(a); 80a-17(b); 80a-23(c); 80a-42(a); 80a-43; and 80a-46(b). They are printed in App. B, *infra*, pp. 58 to 63.

Statement of the Case

The Transactions

Dynamics Corporation of America (Dynamics), an operating company engaged in the electronics business, owned a majority of the common stock and a majority of the preferred stock of Securities Corporation General (SCG), a registered investment company. SCG in turn owned the majority of the common stock of Anemostat Corporation of America (Anemostat), an operating company engaged in the manufacture of air conditioning equipment. SCG's only other asset was stock in Dynamics. Dynamics also owned directly a 23% interest in Anemostat. All three companies have public stockholders.

Dynamics wished to dispose of its investment in SCG but wanted to acquire SCG's ownership of Anemostat. Controlling both corporations, Dynamics could, at any time, have bought SCG's interest in Anemostat and sold to SCG its holdings of SCG preferred. However, since these transactions would not be at arms-length and involved a registered investment company, application would have to be made to the Securities and Exchange Commission under the Investment Company Act of 1940 and an exemption order obtained.

Dynamics sought to accomplish its ends under a plan admittedly designed to avoid any SEC proceeding under the Act. Dynamics sold its controlling common stock in SCG to a group of six people made up of the wife of the Executive Vice President of Dynamics using her maiden name, two friends of the President of Dynamics, a company controlled by one of those friends, a friend and former business associate of the Executive Vice President of Dynamics, and a friend of a Director of Dynamics.

The controlling block of stock was split into six equal parcels and sold at a price fixed by the President of Dynamics. The stock was offered only to those six people and each took his share without any question as to the number of shares or the price. There was no bargaining.

As soon as the stock was sold, Dynamics got the new group together and suggested that they become the directors and officers of SCG, and, at the same time, suggested that SCG turn over its majority stock in Anemostat in exchange for the SCG preferred stock owned by Dynamics.

Thereafter Dynamics arranged a meeting of the Board of Directors of SCG at which the three incumbent Directors controlled by Dynamics resigned seriatim electing as their successors three members of the new group. The old officers also resigned and were replaced by members of the new group.

The new Board thereupon agreed with Dynamics to sell SCG's majority interest in Anemostat in exchange for the SCG preferred stock owned by Dynamics plus a small amount of cash.

The net result of these transactions was that Dynamics disposed of its entire investment in SCG, both common and preferred stock. The common voting stock that controlled SCG went to a group of friends of Dynamics' management. Dynamics and the new group combined to make SCG purchase its own preferred stock. By this means the new group did not have to buy it and Dynamics was not left with it. Part of the price of acquiring Dynamics' investment in SCG was thus paid out of SCG's own assets. SCG parted with its major asset and underwent a partial liquidation that cut the size of the company in half.

The time period covered was about three weeks. On November 2, 1959, the sale of the SCG common stock was completed; on November 4th, Dynamics met with the new group and suggested the exchange; on November 11th, the new group were installed as Directors, and on November 24th the deal was agreed to.

The First SEC Order

At the time, or a little before, the exchange was agreed upon, the parties learned that the plan would not suffice to defeat SEC jurisdiction and that an exemption order must be procured. Dynamics' lawyers thereupon prepared and the new group authorized and filed on behalf of SCG an application for exemption on December 11, 1959. No actual notice was given to the common stockholders of SCG, although notice by mail was given to the preferred stockholders. Constructive notice was given to the common stockholders by publication in the December 19th (Saturday) issue of the Federal Register. This was sent out by second class mail and had no chance, by reason of the Christmas mail and the holiday, of being received in time for any common stockholder to request a hearing. Christmas fell on Friday and the request for a hearing had to be in the hands of the SEC by 2:00 P.M. on Monday, December 28th, the day after the Christmas week-end. In fact, no common stockholder received notice until after the transaction was consummated.

The SEC found the transactions fair and reasonable and issued an exemption order on December 30, 1959 and the transactions were consummated on December 31, 1959.

This order of the SEC was based only upon the written application of the interested proponents of the transaction, without a hearing, without any testimony or cross-

examination, without the participation of any common stockholder or other disinterested party, without disclosure of the violation of Section 16(a) of the Act, and without disclosure of the relationships and transactions between the parties who had negotiated the deal.

The Suit in the Federal District Court

Petitioner Nadler, the owner of more than 7% of the common stock of SCG, after the expiration of the 60 day period provided by Section 43(a) of the Act for the review by a court of orders of the SEC, discovered that the transactions had been carried out in violation of Section 16(a) of the Act and elected to void them. To do so, on April 1, 1960 he brought an action in the District Court for the Southern District of New York to set aside the transactions under Sections 16(a) and 47(b) of the Act, and sought a temporary injunction to preserve the status quo. The suit was brought against Dynamics, SCG and the persons serving as directors in violation of the Act. He had also advised the SEC of the violation and on April 12, 1960 the SEC on its own motion ordered a hearing to determine whether to revoke its exemption order. As a result, the District Court issued an order for a temporary injunction preserving the status quo and staying proceedings in the District Court pending a decision by the SEC on its hearing, which order of the Court was consented to by all parties. The Court refused to enjoin an annual meeting of the stockholders of SCG scheduled to be held on April 13, 1960.

The Attempted Ratification

Five months after the election of the illegal board, at a stockholders meeting on April 13, 1960, the new group,

solely by the vote of the stock that they had purchased from Dynamics, with no other stockholders present or voting, elected their three representatives as directors and voted to ratify the transactions with Dynamics. No notice of the transactions or the proposed ratification was given to the other stockholders. No proxy solicitation under SEC Rules was made. The newly elected directors thereupon met and voted to ratify their own prior acts.

The Second SEC Order

On the hearing to revoke the SEC order, the violation of Section 16(a) was immediately established. Over the protests of the public common stockholders owning 18% of that class, the trial examiner then conducted a lengthy hearing on the "equities". However, in so doing, the trial examiner repeatedly held that he would not retry the issue of the fairness or reasonableness of the transactions allegedly established by the first SEC order, unless the public stockholders first proved actual fraud or overreaching in the transactions, in addition to the violation of Section 16(a). The public stockholders' contention that Section 16(a) established a prophylactic rule and standard of statutory fraud was overruled. So was their contention that the trial of an existing and admitted violation of Section 16(a) of the Act was a matter for the pending action in the District Court under Section 44 of the Act granting the courts exclusive jurisdiction over violations.

Based on the hearing, the Commission found that the violation of Section 16(a) was "inadvertent", had been cured by ratification, and that since the public stockholders had not proven any actual fraud or overreaching, there was no reason for it to re-examine its prior order that the transaction was fair and reasonable. The Commission thereupon discontinued the proceedings by order dated December 23, 1960.

Stipulation in the District Court

In contemplation of a petition being filed by Nadler in the Court of Appeals for the Second Circuit to set aside the SEC orders, a stipulation was entered into in the District Court action by all parties providing for the dismissal of that action if the orders of the SEC were finally sustained. The basic questions of law with respect to the Act raised by that case and on the petition to review the SEC orders were substantially identical.

Proceedings in the Court of Appeals

On February 17, 1961, Petitioner Nadler filed with the Court of Appeals for the Second Circuit a petition that the Court (1) set aside and enjoin the order of the Securities and Exchange Commission dated December 30, 1959 or order the Commission to rescind that order; and (2) review and set aside the SEC order dated December 23, 1960.

Jurisdiction of the Court of Appeals with respect to the SEC order of December 23, 1959 was based upon the inherent power of that Court to protect its appellate jurisdiction, where as here, such order was obtained in violation of Section 16(a) of the Act and such fact was concealed and not discovered until after the time to appeal to that Court from the order had expired. It was also based on the "All Writs Act" 28 U. S. C. 1651.

Jurisdiction of the Court of Appeals to review the SEC order of December 23, 1960 was based on Section 43(a) of the Investment Company Act of 1940, 15 U. S. C. 80a-42(a).

Leave to intervene was granted to Securities Corporation General and Dynamics Corporation of America on consent of the parties.

After the submission of briefs and oral argument, the Court of Appeals affirmed the SEC order of December 23, 1960 and in effect denied the petition to set aside, enjoin or order the rescission of the SEC order of December 30, 1959. The decree and opinion of the Court of Appeals are set forth in App. A, *infra*, pp. 25 and 27, respectively.

Reasons for Granting the Writ

The scope of the protection afforded the public investor by the Federal Securities Laws is a major and ever increasing concern of the Federal Government as witness the present investigations being conducted by the Congress and the Securities and Exchange Commission in that area. The Investment Company Act of 1940 is one of the cornerstones of that protection. This case raises a number of important questions under that Act on which this Court has not passed.

1. Section 16(a) of the Act—the only section to meet with unanimous approval and to go uncontested in the lengthy hearings and negotiations leading to the enactment of that statute—has never been construed or passed upon by this Court, or by any other court until the instant decision of the Court of Appeals. The matter is one of first impression and the construction of that Section should be settled by this Court.

2. The construction placed upon Section 16(a) by the Court of Appeals is in conflict with the purpose and intent of Congress as clearly shown by its legislative history, is contrary to its plain language and meaning, and if permitted to stand renders the Section meaningless and a dead letter. The construction of the Section adopted by the Court of Appeals leads to an absurd result and de-

prives the public investor of the protection intended by Congress.

3. The meaning given to Section 16(a) by the Court of Appeals is contrary to the administrative interpretation given it by the Commission and will substantially hamper the Commission in its administration of the Act and the protection of the public investor. Counsel for the Commission in the Court below never contended for the construction adopted by the Court of Appeals and that Court was misled by an argument by analogy contained in the Commission's brief.

4. The decision of the Court of Appeals implicitly denies that the Act creates rights in the individual public investor separate and apart from any action by the Commission. This is in conflict with that Court's own decision in *Brown* v. *Bullock*, 294 F. 2d 415 (2 Cir., 1961). The Second and Eighth Circuits are in conflict on this point (see *Brouk* v. *Managed Funds Inc.*, 286 F. 2d 901 (8 Cir., 1961) cert. granted 366 U. S. 958), one of far reaching importance on which this Court has never passed and which should be settled by this Court. Although certiorari was granted by this Court in the *Brouk* case, Petitioner is informed that the case may be settled before it is heard by the Court and the opportunity in that case to settle the question will be lost.

5. This case also raises a fundamental question of widespread importance as to the respective rights of the Securities and Exchange Commission and the public investor under the Federal Securities Laws, namely, whether the public investor is the ward of the SEC and powerless to assert his rights on his own behalf when the Commission through error or by deliberate intent refuses to take action in the courts on an admitted violation of law.

ARGUMENT

POINT I

The Court of Appeals' construction of Section 16(a) is contrary to its purpose, intent and plain meaning, leads to an absurd result, and renders the section meaningless.

Section 16(a) of the Act by its express language prohibits a board elected by the device of seriatim resignations from serving as directors of a registered investment company, see App. B, *infra*, p. 59. The purpose and intent of that Section was to prevent the fast inside deal, i.e. the sale or manipulation of company assets accompanying a shift in management control without notice to the public stockholders.

It is seldom that you can find a case where the legislative history so vividly illumines the purpose and intent of the statutory wording. The SEC had made an exhaustive study of investment companies and the abuses in their operation which had resulted in enormous loss to the public investor. *SEC Report on Investment Trusts and Investment Companies (1940)*, Part 3, Chap. IV, page 1017 et seq. and page 1877 et seq. For several hundred pages that report goes into the detailed case histories of scores of investment companies showing the manipulation of the control and the assets of those companies to the public detriment. In every case the manipulation of assets was made possible, or facilitated, by the quick change in control of the management of the investment company through the device of the seriatim resignations of directors and the election by them of their successors. In some instances the controlling parties held an actual majority of the voting stock, but in every instance they had prac-

tical working control so that it lay in their power to secure majority stockholder action when necessary. In fact they often did so—after the event.

The SEC Report concluded that the device of seriatim resignations to elect directors without notice *to all* of the stockholders was one of the contributing factors to the abuse of power by those controlling investment companies and that it should be outlawed. Section 16(a) was enacted to outlaw that device and does so explicitly and effectively.

The effect and purpose of Section 16(a) is well stated by Mr. Alfred Jaretzki, Jr., who participated actively in the drafting of the Act and its adoption into law:

> "At least one provision of the original bill received more or less universal approbation. That was the provision now found in Section 16(a) stating that no person may serve as a director of a registered investment company unless elected by stockholders at an annual or a special meeting duly called for that purpose, except, in effect, that vacancies occurring between such meetings, not in excess of one-third in all, may be filled in any otherwise legal manner. This provision, it was universally agreed, should prevent the recurrence of a situation which had on several occasions led to serious losses to stockholders. Directors had turned over control to a new board without stockholders' action, and indeed without notice to stockholders, by the familiar procedure of successive single resignations of directors immediately supplanted by new members.
>
> It is true that even with this provision, voting control of an investment company could be purchased by unscrupulous persons who could thereupon elect new directors and presumably have the company operated to their advantage rather than in the interests of stockholders. Under Section 16 stockholders are at least put on notice of any proposed change and a regular corporate vote is re-

quired for such purpose. Experience has shown that the most scandalous practices were possible only where the new management, which proposed to acquire its control with the funds of the corporation itself, could step in without any delay. Such delay, with stockholders' meeting regulated by the proxy machinery, should go a long way towards preventing at least flagrant abuses and to giving dissatisfied stockholders sufficient opportunity to avail themselves of normal legal remedies. * * *" *Washington University Law Quarterly* Vol. XXVI —pp. 323-324. (1941).

See also 50 *Yale Law Journal*. 440, 447.

The wording of Section 16(a) was patterned upon that of Section 118 of the New York Banking Law which had been in effect for many years (see *SEC Report on Investment Trusts*, supra, footnote 27, page 1029) and the pertinent part of which reads:

> "All vacancies in the office of director shall be filled by election by the stockholders, except as herein after provided. Vacancies not exceeding one-third of the whole number of the board may be filled by the affirmative vote of a majority of the directors then in office * * *" *McKinney's Consolidated Laws of New York Annotated*. Vol. 4, Part 1, page 258.

The difference in wording is significant. The New York statute provides that vacancies in the board shall be filled by the stockholders. The New York legislature could do so because it was dealing with corporations formed under New York law. Congress, however, recognized that it was legislating with respect to companies formed under the laws of the several states, many of which permitted vacancies in the board of directors to be filled by the remaining

directors. Congress did not, therefore, seek to change the corporate laws of the various states as to the method of electing directors. But it did provide by federal law that unless a director was elected by the stockholders, he could not serve as a director of a federally regulated investment company. The purpose was to outlaw the device of seriatim resignations to elect directors; the intent was to stop a director so elected from acting for the corporation; and the statutory language effectuated that purpose and intent by clear and unambiguous language prohibiting such a person from "serving" as a director.

This disposes once and for all of the contention that persons elected as directors in violation of Section 16(a) can serve as *de facto* directors. The express language of the law stops them from serving in any guise. Congress knew that directors elected through the device of seriatim resignations were *de jure* under the corporate laws of many states. To argue that Congress intended to stop such persons from acting as *de jure* directors but not to stop them from acting as *de facto* directors is absurd. Furthermore, to permit such persons to act as *de facto* directors, or to give validity to their acts, unless voidable at the election of a public stockholder, nullifies the whole statutory scheme and destroys Section 16(a) completely. Such a view means that a quick shift of control and manipulation of assets without notice to all of the stockholders could still be accomplished, the very evil at which the statute was aimed and (we contend) effectively prevents.

After laying down this flat prohibition in the first sentence the Section goes on in the second sentence to deal with an entirely different situation, see App. B, *infra*, p. 59. Congress realized that despite the first sentence of the Section and full compliance with it, death

or resignations in the normal course of events could result in reducing even a validly elected board to a point where less than a majority of its members had been elected by the stockholders. In such event, Congress provided for the calling of a stockholders meeting but made no prohibition against the validly elected board continuing to act in the meantime.

The Court of Appeals in its opinion, App. A, *infra*, p. 29, has erroneously construed Section 16(a) to mean that a board elected in violation of the first sentence of that Section can serve and act until a new board is properly elected within sixty days in accordance with the provisions of the second sentence of the Section. The Court held:

> "We see no basis for the conclusion that all acts by a board not chosen as required by Section 16(a) must be considered void. The statute indicates that such a board has power to take action to secure a properly chosen board within a sixty-day period, which may be extended by the Commission."

Such a construction not only is contrary to the express language of the statute but completely defeats the purpose and intent of the Section and renders it meaningless as far as any protection to the public stockholder is concerned.

If such an illegally elected board can immediately sell the assets of the registered investment company to the persons who put them in control and effect a partial liquidation of the company, the purpose and intent of the Section is defeated.

If such an illegally elected board can validly act for sixty days the Section affords no protection to the public stockholder.

Instead of preventing the abuses at which the Section is aimed, the construction of the Court of Appeals places the stamp of legality upon them, and puts a premium upon the speed of their accomplishment.

Calling a stockholders meeting to elect a proper board sixty days after the illegally elected board has acted to dispose of the company's assets is a classic example of locking the stable door after the horse is stolen.

To attribute such an absurd purpose to the SEC, who sponsored the bill after long and intensive study, and to the Congress, who enacted it after full hearings and careful consideration, is both unwarranted and unnecessary.

The Court ignored the guide to the interpretation of the Act laid down by Congress in Section 1(b), see App. B, *infra*, p. 58. Moreover it violated the cardinal rule of construction that a statute is not to be given a reading which would lead to an absurd result when it can be given a reasonable application consistent with its words and with the legislative purpose. *Haggar Co.* v. *Helvering*, 308 U. S. 389, 394.

The Section clearly provides that the illegally elected directors shall not "serve". The second sentence of the Section clearly refers to a situation arising with respect to a legally elected board in the normal and ordinary course of events and not to the deliberate and wholesale violation of the flat prohibition contained in the first sentence. If it has any application in the instant case, it merely provides that a stockholders meeting be held in sixty days to elect a proper board, which was not done in this case. It certainly cannot be construed as condoning the violation of the first sentence, permitting the violators to act with impunity during the sixty-day period

when the Section says they shall not serve, and preventing the public investor from electing to void their acts during the period that they have illegally served. The two sentences of the Section are not conflicting and can be easily reconciled to give a meaningful construction to the Section in accordance with its clear purpose and intent.

It is to be noted that the Commission has not, either in the proceedings before it in this matter or in any other administrative interpretation of which we are aware, ever asserted or adopted the construction placed on Section 16(a) by the Court of Appeals in its opinion. In its brief to the Court below, counsel for the Commission did argue by analogy that since it had certain discretion under the express provisions of the second sentence of Section 16(a), that it must also have it under the first sentence. We believe that this argument was misunderstood and misinterpreted by the Court of Appeals to be a statement of administrative interpretation that a board elected in violation of Section 16(a) could legally act for sixty days and that its actions could not be voided.

POINT II

An individual public stockholder of a registered investment company has an independent right to void transactions in violation of the Act.

That the Investment Company Act of 1940 was enacted for the protection of the public stockholder in investment companies is expressly stated in its "Findings and Declaration of Policy" in Section 1 of the Act, see App. B, *infra*, p. 58. Petitioner contends that acts in violation of a statute declaring the public policy of the State are void, and in any event are voidable at the election of one of the class for whose protection the Act was adopted. See *Westerlund* v. *Black Bear Mining Co.*, 203 Fed. 599, 611-613 (8 Cir., 1913); cf *Texas & P. R. Co.* v. *Rigsby*, 241 U. S. 33, 39-40.

Promptly upon learning of the violation of Section 16(a), Petitioner elected to void the transaction and the Order of the SEC dated December 30, 1959 and brought an action in the U. S. District Court for the Southern District of New York on April 1, 1960 to have the transaction set aside. The action was brought pursuant to Section 31 of the Act, see App. B, *infra*, p. 62, which vests in the courts exclusive jurisdiction of violations of the Act.

Petitioner's election and suit were based on the violation of Section 16(a) of the Act and on Section 47(b) which provides that every contract made in violation of any provision of the Act or the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, the Act shall be void; see App. B, *infra*, p. 63.

This election was made and suit was brought before any meeting of the stockholders was held to elect proper directors or any attempt at ratification, and before any action was taken by the SEC with respect to the revocation of its December 30, 1959 order.

Petitioner respectfully submits that the action which he took voided the transaction and that, upon the commencement of the action in the District Court, that Court had exclusive jurisdiction over the violation of Section 16(a), its effect and the remedy therefor.

Petitioner contends that ignorance of the law, characterized as "inadvertence", does not excuse the violation; that the violation is not cured by the violators subsequently ratifying their own illegal acts without the consent of all of the stockholders or at least a disinterested majority; and that a public stockholder is not required to prove actual fraud in addition to a violation of the Act in order to avail himself of the protection which it affords.

Petitioner further contends that these are questions of law for the independent judicial determination of the courts.

Petitioner's right to such a determination is not dependent upon the acquiescence or consent of the SEC. Even where the Commission by error or deliberate intent refuses to take action upon a violation, this does not debar the public stockholder from the assertion of his independent rights under, and the protection afforded him by, the Act. (Cf. *Goldstein* v. *Groesbeck*, 142 F. 2d 422 (2 Cir., 1944) cert. denied 323 U. S. 737.

The Court of Appeals denied this independent right of the public stockholder and placed the enforcement of violations in the sole discretion of the Commission when it held:

> "It would be an unsound policy, fraught with harm to the shareholders, to have everything done by such a board to carry on the corporation's normal business, especially within the statutory period, declared invalid. The Commission acted properly in carefully scrutinizing transactions during the interim period and in not voiding transactions found to be reasonable and proper in themselves."

This makes the public investor the ward of the SEC, powerless to act in his own behalf if the Commission in its discretion elects not to seek enforcement of a violation of the Act.

The Court of Appeals erred in several respects. First, the Court erroneously assumes that the Commission has the power to void transactions. This is not so; that power is reserved exclusively to the courts by Section 44. Under the scheme of the Act, the Commission has only the power to grant exemptions. It has, itself, no powers of enforcement. To enforce a violation it must proceed in the courts just like a private litigant.

Second, the transactions which the public stockholder elected to void were not the corporation's normal business, but the sale of its major asset to a company which had just sold control to the purported directors and placed them in office, and the exchange of its own preferred stock for that asset, which effected a partial liquidation of the investment company and cut its size and assets in half. For a company that had not changed its portfolio in ten years, these drastic steps, under such circumstances, cannot be deemed under any standards to be "normal business." These specific transactions and the acts taken to accomplish them are the only acts Petitioner elected to void.

Third, the policy which the Court of Appeals finds unsound is nevertheless the policy adopted by Congress after careful consideration and with good reason. As we have seen, *supra*, Congressional policy has established by statute a prophylactic rule to curb certain serious abuses in the operation of investment companies. Whether all acts of the illegally elected directors are invalid as to innocent third parties is open to question, but it was certainly the policy of Congress to permit a public stockholder to void the acts of which the Petitioner here complains.

Contrary to the holding of the Court of Appeals in this case, Petitioner believes that it was the intent of Congress that the individual public stockholder in a registered investment company have the right to avail himself directly of the protection afforded by the Act enacted for his benefit.

This question has not been settled by this Court.

Opposing conclusions on the basic question, although on different facts than here presented, have been reached by the Second Circuit and the Eighth Circuit in the cases of *Brown* v. *Bullock*, 294 F. 2d 415 (2 Cir., 1961), and

Brouk v. Managed Funds, Inc., 286 F. 2d 901 (8 Cir., 1961) cert. granted 336 U. S. 958, respectively.

Support of the public stockholder's position is to be found in *Goldstein v. Groesbeck* 142 F. 2d 422 (2 Cir., 1944) cert. denied 323 U. S. 737, which upheld his right to direct action under the Public Utility Holding Company Act of 1935, 15 U.S.C. 79a-79z.

The question presented is one of far-reaching importance to the protection of the public investor under the Federal Securities Laws and to the proper administration of the Act.

POINT III

The public stockholder has been deprived of his day in court and a trial on the merits of a violation of the Act.

It seems a harsh result that, by reason of a violation of law by those standing in a fiduciary relationship to the public stockholders, taken together with a mistake by the Commission, the public investor is deprived of his day in court and a trial on the merits of transactions in violation of the Act. This nevertheless is the result of the Court of Appeals' opinion sustaining the Commission's orders.

The first SEC order was granted, without a hearing, on three and one-half days' constructive notice in the Federal Register sent out by second class mail during Christmas week. The public common stockholders never had a chance to, and did not, participate in any trial on the merits of the transactions in this first proceeding. The public stockholders also never had a chance to contest that order as being in violation of Section 16(a), since the fact was concealed and never disclosed to them.

The SEC's second order, despite an admitted violation of Section 16(a), refused to re-examine the transactions on the merits on the ground that the burden of proving actual fraud in addition to a statutory violation was on the public stockholders.

There have never been any proceedings before the SEC for an order exempting the transactions from Section 16(a) of the Act in which the public stockholders could have been heard on the merits of the transactions.

The result is that to date the public stockholders have never participated in any hearing or trial on the merits of the transactions and have never had an opportunity to do so. Yet these transactions were prohibited by Sections 17(a) and 23(c) and were void under Sections 16(a) and 47(b) of the Act.

On the Section 16(a) violation, the public stockholders have never had a trial by a court, even though jurisdiction thereof is exclusively reserved to the courts by Section 44 of the Act.

Although an action with respect thereto was pending in the District Court, the SEC usurped that jurisdiction and decided the question of the Section 16(a) violation on the legal grounds that the violation was inadvertent, cured by ratification, and that no actual fraud was proven.

The Court of Appeals adopted the Commission's opinion without an independent judicial examination of the legal issues, on the erroneous assumption that the question fell within the proper administrative jurisdiction and discretion of the Commission.

The opinion of the Court of Appeals and the SEC orders, effectively foreclose the public stockholders from any trial of the Section 16(a) violation, or the merits of the transactions, in the District Court. This was recog-

nized by Petitioner when he stipulated to the discontinuance of the District Court action if the Commission's orders were finally sustained. It would be true if there were no such stipulation.

Errors and procedural maneuvers have left the public investor without a remedy. This result is unjust and not in accordance with law. The public investor should not be deprived of his right to a trial in the courts of a violation of a statute enacted for his protection.

It is respectfully submitted that the Commission would be aligned on the side of the public stockholder in this case were it not for the error of its staff in permitting the original order to be issued in violation of Section 16(a) and its very human reluctance to acknowledge that fact.

CONCLUSION

For the foregoing reasons, Certiorari should be granted to review the decree of the Court below.

Respectfully submitted,

CAMERON I. KAY,
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New York 6, New York,

ROBERT REED GRAY,
1001 Connecticut Avenue,
Washington 6, D. C.,
Attorneys for Petitioner.

HAROLD L. MEYERSON,
JACK L. MOST,
Of Counsel.

Dated: New York, February 7, 1962.

APPENDIX A

Decree and Opinions Below

ORDER

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 26810.

AARON M. NADLER, *Petitioner,*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*

SECURITIES CORPORATION GENERAL, *Intervenor,*

DYNAMICS CORPORATION OF AMERICA, *Intervenor.*

Aaron M. Nadler, a common stockholder of Securities Corporation General, having filed a petition for review of an order of the Securities and Exchange Commission entered on December 23, 1960, which declined to revoke a previous order of the Commission entered on December 30, 1959, granting an exemption from Section 17(a) of the Investment Company Act of 1940, pursuant to Section 17(b) thereof, for a proposed sale by Securities Corporation General to Dynamics Corporation of America of its stock holdings in a third corporation (Anemostat Cor-

poration of America), and which permitted, pursuant to Section 3(c)(3) of the Act, Securities Corporation General to receive in exchange certain shares of its own preferred stock held by Dynamics Corporation of America, as well as cash;

Briefs having been filed by the parties, this Court having heard argument and having issued its opinion on October 31, 1961; on the basis of said opinion, it is hereby

ORDERED, ADJUDGED AND DECREED that the aforesaid order of the Securities and Exchange Commission be and the same is hereby affirmed.

By the Court:

CHARLES E. CLARK

Circuit Judge

STERRY R. WATERMAN

Circuit Judge

Date: November 14, 1961

(SEAL)

A true copy,
A. Daniel Fusaro
Clerk

Appendix A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 22—September Term, 1961.

(Argued October 11, 1961 Decided October 31, 1961.)

Docket No. 26810

AARON M. NADLER,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent,

SECURITIES CORPORATION GENERAL,

Intervenor,

DYNAMICS CORPORATION OF AMERICA,

Intervenor.

Before: CLARK, WATERMAN, and MOORE, Circuit Judges.

Petition for review of an order of the Securities and Exchange Commission.

Aaron M. Nadler, a common stockholder of Securities Corporation General, petitions for review of an order of the Securities and Exchange Commission declining to revoke its prior order which had granted exemption from 17(a) and 23(c)(3), Investment Company Act of 1940, 15 U. S. C. §80a—17(a), §80a—23(c)(3), for sale of stock

by the Corporation, and discontinuing all proceedings as to the matter. Affirmed.

CAMERON L. KAY, of Hale, Kay & Grant, New York City, *for petitioner*.

MICHAEL S. RIGGER, Asso. Gen. Counsel, Securities and Exchange Commission, Washington, D. C. (Allan F. Conwill, Gen. Counsel, and Paul J. Kemp, Atty., Securities and Exchange Commission, Washington, D. C., on the brief), *for respondent*.

BERNARD D. CAVEN, New York City (Arthur W. Murphy and Stephen F. Selig, New York City, on the brief), *for intervenor Securities Corporation General*.

BRUCE BROMLEY, of Cravath, Swaine & Moore, New York City (Allen F. Maulsby, Alan R. Finberg, and John W. Barnum, of Cravath, Swaine & Moore, New York City, on the brief), *for intervenor Dynamics Corporation of America*.

PER CURIAM:

On December 30, 1959, the Securities and Exchange Commission, pursuant to 17(b) of the Investment Company Act of 1940, 15 U. S. C. (80a—17(b), granted an exemption of 17(a), thereof, 15 U. S. C. (80a—17(a), for a proposed sale by Securities Corporation General to Dynamics

Appendix A

Corporation of America of its stock holdings in a third corporation (Anemostat Corporation of America), and (also pursuant to 23(c)(3) of the Act, 15 U. S. C. 80a-23(c)(3), permitted SCG to receive in exchange certain shares of its own preferred stock held by DCA, as well as cash. The present petition for review, brought by Nadler as a common stockholder of SCG, is from a Commission order of December 23, 1960, holding that no basis exists to revoke the prior order. Nadler's attack is based upon the claim that the SCG directors who sought the exemption were improperly chosen under 16(a) of the Act, 15 U. S. C. 80a—16a—being elected by the board of directors, rather than by the shareholders at a shareholders' meeting. The Commission, after hearing, found that there was a failure to comply with this provision, but that the failure was inadvertent and the persons involved were the major beneficial owners of the company and could have elected the same persons as directors and did so at the next regular stockholders' meeting in accordance with 16(a). Then it made an extensive review of the evidence and found that there was no evidence of fraud or overreaching in the transaction and that the terms and considerations of the transaction were fair and reasonable. So it declined to revoke its exemption.

These findings, which are supported by the evidence, are crucial against the petitioner's claim. We see no basis for the conclusion that all acts by a board not chosen as required by 16(a) must be considered void. The statute indicates that such a board has power to take action to secure a properly chosen board within a sixty-day period, which may be extended by the Commission. It would be an unsound policy, fraught with harm to the shareholders,

to have everything done by such a board to carry on the corporation's normal business, especially within the statutory period, declared invalid. The Commission acted properly in carefully scrutinizing transactions during the interim period and in not voiding transactions found to be reasonable and proper in themselves. Nadler's further claims of inadequate hearing and lack of notice must fall because of the undoubted fact that eventually he was given a very full hearing.

Affirmed.

Order Discontinuing Proceedings

UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

December 23, 1960

In the Matter of

SECURITIES CORPORATION GENERAL

File No. 812—1273

Investment Company Act of 1940

Proceedings having been instituted to determine whether the Commission should revoke its order of December 30, 1959, issued pursuant to Sections 17(b) and 23(c) of the Investment Company Act of 1940, exempting from the

provisions of Section 17(a) of that Act the proposed acquisition by Dynamics Corporation of America from Securities Corporation General, a registered closed-end non-diversified investment company, of 77,395 shares of the common stock of Anemostat Corporation of America, an affiliated person of both of the said corporations, and permitting Securities Corporation General to acquire, as part of the consideration, 4,757 shares of its preferred stock;

Hearings having been held after appropriate notice, a recommended decision having been waived, briefs and reply briefs having been filed, and oral argument having been heard;

The Commission having this day issued its Findings and Opinion, on the basis of such Findings and Opinion

It Is Ordered that these proceedings be, and they hereby are, discontinued.

By the Commission.

Orval L. DuBois
Orval L. DuBois
Secretary

0-40-3165

Appendix A

Findings and Opinion of the Commission

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

December 23, 1960

In the Matter of

SECURITIES CORPORATION GENERAL

File No. 812-1273

Investment Company Act of 1940

TRANSACTIONS BETWEEN AFFILIATED PERSONS

Sale of Assets by Registered Investment Company

REVOCATION OF PRIOR EXEMPTIVE ORDER

Where directors of a registered investment company, who authorized a sale of assets and an application to the Commission for an exemption order under Section 17(b) of the Investment Company Act to permit such sale, were not elected at a stockholders' meeting as required by Section 16(a) of Investment Company Act, but failure to comply with such section was inadvertent, the persons involved were the major beneficial owners of the company and could have elected and at the next regular stockholders' meeting did elect same persons as directors in compliance with Section 16(a), there is no evidence of fraud or overreaching in the transaction or in the submission of the exemption application to the Commission, the proposed sale was reviewed by the Commission, which

granted an exemption on the basis of findings that the terms and consideration of the transaction were fair and reasonable and did not involve overreaching, and the parties thereto thereafter consummated the transaction in accordance with the order of exemption, *held*, under all the circumstances no basis exists to revoke the prior exemption order.

APPEARANCES:

Bernard D. Cahn, for Securities Corporation General.

Roswell L. Gilpatric and *Alan R. Finberg*, of Cravath, Swaine & Moore, and *Francis E. H. Davies*, of Goodwin, Rosenbaum, Meacham & White, for Dynamics Corporation of America.

Cameron L. Kay, of Hale, Kay & Grant, for Aaron M. Nadler and other common stockholders of Securities Corporation General.

Frank Field and *Kieran T. Ridge*, for the Division of Corporate Regulation of the Commission.

On December 30, 1959, upon the application of Securities Corporation General ("SCG"), a registered closed-end non-diversified investment company, we issued an order,[1] pursuant to Sections 17(b) and 23(c) of the Investment Company Act of 1940 ("Act"), exempting from the provisions of Section 17(a) of the Act the acquisition by Dynamics Corporation of America ("DCA") from SCG of 77,395 shares of the common stock of Anemostat Corporation of America ("Anemostat"), an affiliated

1. Investment Company Act Release No. 2958.

person of both SCG and DCA, and permitting SCG to acquire from DCA, as part of the consideration for the Anemostat shares, 4,757 shares of SCG preferred stock. The present proceedings were instituted to determine whether that order should be revoked on the grounds that the purported directors of SCG at the time of the sale of the Anemostat stock and at the time the application was filed had not been elected in accordance with the provisions of Section 16(a) of the Act,[3] and that the application filed on behalf of SCG by its purported president pursuant to a resolution of such directors violated Rule O-2 (17 CFR 270.0-2) under the Act, in that such president was elected by directors who had not been elected in accordance with the provisions of Section 16(a).[4]

2. Section 17(a) of the Act, insofar as pertinent, prohibits an affiliated person of an affiliated person of a registered investment company from purchasing any security from such investment company. Under Section 17(b), we must grant an exemption from this prohibition if we find that the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair and do not involve overreaching, that the proposed transaction is consistent with the stated policy of each registered investment company concerned, and that it is consistent with the general purposes of the Act.

Section 23(c) of the Act, as here applicable, prohibits a registered closed-end investment company from purchasing securities issued by it except under such circumstances as we may by order permit for the protection of investors.

3. Section 16(a) of the Act provides in part: "No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting."

4. Under Rule O-2, every application by a corporation for an order must contain a statement that the person signing and filing the application on behalf of the applicant is authorized to do so.

Appendix A

After appropriate notice, hearings were held before a hearing examiner. A recommended decision by the hearing examiner was waived, and briefs and reply briefs were filed by SCG in support of the order, and by Aaron H. Nadler, and other common stockholders of SCG, who urged revocation of such order. DCA, which in connection with its application for leave to be heard had submitted a memorandum supporting the order, associated itself with the briefs filed by SCG. The Division of Corporate Regulation ("Division") filed proposed findings and a brief in support of the order, but subsequently filed a statement recommending a reopening of the record for certain limited purposes. We heard oral argument. Our findings are based upon an independent review of the record.

BACKGROUND

Prior to October 1959, DCA, a company engaged in the manufacture of electronic and related products, controlled SCG through the ownership of 150,593 shares or about 55% of the outstanding common stock of that company. SCG's assets consisted principally of 131,355 shares or 4.95% of DCA's outstanding common stock and the 77,395 shares, constituting 51.25% of the outstanding shares, of the common stock of Anemostat, which is engaged in the manufacture of equipment for air conditioning systems. DCA owned 32.87% of the outstanding stock of Anemostat.

In October 1959, DCA sold its holdings of SCG stock, in blocks of approximately 25,000 each, to John R. Peddy, G. B. Henderson, David Finkle, and three other persons. At a special meeting of SCG's board of directors held on November 11, 1959 for the purpose of replacing the

existing board, which consisted of nominees of DCA, the president resigned as director and president and the two remaining directors elected Peddy to those positions. The other directors then resigned *seriatim* and were replaced by Finkle and Henderson. The application with respect to DCA's acquisition of the Anemostat stock was executed and filed with us on behalf of SCG by Peddy on December 11, 1959, pursuant to a resolution adopted by the new board of directors.

After publication of the notice of filing of the application, a request for a hearing was made by a holder of preferred stock of SCG but that request was subsequently withdrawn. Our order of exemption was issued on the basis of our consideration of the application and attached appraisal reports and our finding that the granting of the exemption was consistent with the policy of SCG and with the general purposes of the Act and that the terms of the proposed transaction, including the consideration to be paid, were reasonable and fair and did not involve any overreaching on the part of any person concerned. The day following the issuance of the order, and in accordance with its terms, the transaction was consummated with DCA paying for 56,195 shares of Anemostat by the transfer of the 4,757 shares of SCG preferred stock held by it, and purchasing the remaining 21,200 shares for cash totalling $155,820. Pursuant to a condition in our order, SCG invited tenders at specified prices of the remaining 1,817 shares of its outstanding preferred stock, which were publicly held, and 975 shares were tendered and were purchased by SCG for a total of

5. Investment Company Act Release No. 2948 (December 10, 1959).

$92,415. In addition, also in compliance with the conditions of our order, SCG expended $10,772 to eliminate the dividend arrearages on the preferred shares which were not tendered for repurchase.

At a regular annual stockholders' meeting of SCG held on April 13, 1960, a majority of the shares were voted to ratify the sale of the Anemostat stock and all acts and transactions of the officers and directors during 1959 and to the date of the meeting, and to elect Peddy, Finkle and Henderson as directors.[6] The directors then likewise voted to ratify all acts and transactions of the officers and directors during 1959 and to the date of the meeting.

NON-COMPLIANCE WITH SECTION 16(A) AND EFFECT THEREOF

Prior to October 1959, DCA understood from our staff that it would be appropriate and desirable under the Act to eliminate the circular and cross-ownership by which DCA owned stock in SCG and SCG owned DCA stock and they both held stock in Anemostat.[7] For this and other reasons DCA wished to dispose of its SCG stock, and it also wished to acquire SCG's block of Anemostat shares. DCA sold its SCG stock after it was advised by its counsel that if its SCG stock were sold to purchasers who were in no way affiliated with DCA, without any reference to

6. Nagler unsuccessfully sought to enjoin the holding of the annual meeting, and he and the stockholders associated with him did not attend. The shares voted at the meeting were those of the six majority stockholders who had acquired their shares from DCA.

7. Sections 20(c) and (d) of the Act evidence a legislative policy to eliminate and prohibit cross-ownership, defined to exist when each of two companies owns more than 3% of the voting securities of the other, as well as circular ownership which exists when two such companies in addition each own more than 3% of the voting securities of a third company.

and not conditioned on any possible subsequent acquisition of SCG's Anemostat stock. DCA could thereafter negotiate with a new independent management of SCG for the acquisition of the Anemostat shares without any conflict with the prohibitions of Section 17(a) and therefore without the necessity for an application to us for an exemption under Section 17(b) of the Act. After the negotiations with the new management of SCG began and before the Anemostat transaction was consummated, however, the parties were advised, on the basis of informal discussions with our staff, that the transaction did come under Section 17(a) of the Act in view of the fact that Anemostat was an affiliate of both SCG and DCA. Accordingly, an application for a Section 17(b) exemption was filed and, as noted, was granted by our order of December 30, 1959.

While not disputing that at least the election of Finkle and Henderson failed to comply with the requirements of Section 16(a) of the Act,[8] SCG and DCA contend that under all the circumstances the order for exemption should not be revoked. They urge that in causing the election of the new directors the new stockholders acted in good faith in accordance with State law and the provisions of SCG's by-laws,[9] that any violation of Section 16(a) was

8. Nadler contends that Peddy's election also was illegal as part of an integrated plan to replace all the directors in violation of Section 16(a). SCG, DCA and the Division, on the other hand, contend that Peddy was legally elected, under the specific terms of that section. We do not deem it necessary to resolve this question, since it is clear that a majority of the board was not elected in compliance with Section 16(a).

9. State law and corporate by-laws could not, of course, authorize procedures directly contrary to the specific provisions of Section 16(a) with respect to the election of directors of registered investment companies under the Act.

unintentional and inadvertent, and that if the new stockholders had been aware of the requirements of Section 16(a) they could have on short notice called a special meeting of stockholders to elect the same persons as directors, a result which was in fact achieved in compliance with Section 16(a) when the same three persons were elected as directors at the annual stockholders' meeting in April 1969. In this connection it is asserted that the violation in the instant case was not the kind that Section 16(a) was primarily aimed at, since the new stockholders here owned the requisite amount of voting shares needed to elect directors at a stockholders' meeting; that the violation of Section 16(a) did not result in any injury to the public or to stockholders; that the Anemostat transaction was entered into in good faith, was in the best interests of SCG and its stockholders, and had been scrutinized by us and found to be fair and reasonable; and that the fairness of the transaction was not affected by the method of election of the persons authorizing the submission of the application for exemption. Finally, while also urging that the application for exemption and our order based thereon are valid because, among other things, officers and directors acting in good faith on behalf of a corporation may validly carry on its business even though by reason of some defect in their election they are only *de facto* officials, SCG and DCA contend that in any event an unintended violation of Section 16(a), which does not impair the fairness and equity of a transaction subjected to the scrutiny and review of this Commission, does not require such drastic action as revocation of the exemption order, and that such revocation would not be in the public interest and would be detrimental to the interests of investors in these companies.

Appendix A

Nadler learned of the proposed Anemostat transaction on or about December 28 or 29, 1959, and in the course of the next two or three weeks discussed it with representatives of SCG, DCA and our staff. During this period he also learned of SCG's new management from a representative of DCA as well as from the information disclosed in ownership reports previously filed with us pursuant to the Investment Company Act of 1940. Apparently Nadler did not become aware of the failure to comply with Section 16(a) until March 1960. His letter dated March 29, 1960, he brought the matter to our attention, and this led to the institution of the present proceedings.

The basic contention of Nadler and the other SCG stockholders associated with him is that the SCG directors were not legally elected and that therefore the Anemostat transaction, the application filed by SCG, and our order based thereon are all void. They urge that this conclusion must necessarily follow from the terms of Section 16(a) itself, as well as from its legislative history, which reflect a Congressional intent to prevent a "fast and inside deal" even when the insiders have voting control of the company; that we have no power to lift the absolute prohibition imposed by that Section; that the violators cannot cure the illegality by ratification; and that any other interpretation would render Section 16(a) meaningless, since some other violation of the Act or fraud would then have to be proved to upset the actions of an illegally elected board. They also contend that the insiders accomplished the sale of a major asset, a change in SCG's investment policy and a partial liquidation of that company, without notice to and the consent of SCG's common stockholders. In addition, these stockholders contend that the new SCG

Appendix A

directors with close friends or business associates of officials of IDCA, that there was overreaching on the part of IDCA, and that the exemption application was designed to create the appearance of an arm's-length transaction and failed to disclose the circumstances surrounding the sale of the SOG common stock by IDCA, the subsequent change of SOG's management and the Anemostat transaction itself.

Section 16(a) is designed to implement the policy of the Act that the shareholders of investment companies have the right to select their directors, by requiring that directors be elected by shareholders at regular or special meetings called for that purpose, with certain exceptions respecting the filling of vacancies occurring between such meetings.[10] The Section thus serves an important purpose in the administration of the Act. To keep the control of investment companies in the security holders, and non-compliance with its terms is not to be condoned or lightly viewed. We do not agree with Nadler's contentions, however, that upon finding a violation of Section 16(a), we have no discretion but to revoke or rescind our Section 17(b) order with respect to the Anemostat transaction.

10. Section 1(b) of the Act declares that the national public interest and the interest of investors are adversely affected when, among other things, the control of management of investment companies is transferred without the consent of their security holders.

11. This Commission's study and report and the Congressional hearings out of which the Act evolved revealed that the control of investment companies had frequently been transferred without the consent of or even notice to stockholders, and that in certain instances the new managements had been guilty of gross mismanagement. See Senate Report No. 1775, 76th Cong., 3rd Sess., p. 7 (1940); House Report No. 2639, 76th Cong., 3rd Sess., p. 9 (1940); Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, Part Three, pp. 1023, 1874-1881 (1940).

Appendix A

Under the circumstances of the instant case, where persons purporting to and in fact, exercising the functions of directors authorized an application to us for an exemption pursuant to Section 17(b) of the Act, where we, after consideration of the application, issued such an order of exemption, where the purported directors have consummated the transaction in reliance on such order and where it does not appear that any of these acts would have been illegal or beyond their authority and power if performed by a legally elected board of directors, in our opinion the defect in the election of the board of directors makes our order voidable but does not make it void. This conclusion is not contrary to the provisions of Section 16(a) or of any other section of the Act,[12] and it is con-

12. There is a general principle of law giving validity under certain circumstances to the acts of *de facto* officers, that is, persons whose election was illegal or invalid, but who are in actual possession of an office under claim and color of an election and who are continuously exercising its functions, if such acts would have been within the scope of official authority if performed by properly elected officers. See Fletcher, *Cyclopedia of the Law of Private Corporations*, Sections 372-390 (Perm. Ed., 1954 Revised Volume). While the doctrine of *de facto* officers may not be strictly applicable under the special circumstances of this case, the considerations underlying such doctrine may be taken into account and are of some significance.

13. Nadler contends that the Anemostat transaction was void under Section 47(b) of the Act. That Section provides in pertinent part that every contract made in violation of any provision of the Act or whose performance involves such violation shall be void (1) as regards the rights of any person who in violation of any such provision shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of such provision. In our opinion, however, this section relates only to contracts whose provisions, or whose performance, violate substantive provisions of the Act, and cannot be said to apply to a sale of securities based on any exemptive order issued by us absent a showing of fraud in the application therefor.

sistent with the over-all purposes of the Act to serve the public interest and protect the interests of investors.

Nor does this approach render Section 16(a) meaningless, as Nadler contends. Persons seeking to serve as directors of an investment company in violation of the requirements of Section 16(a) are subject to ouster and other appropriate sanctions in direct proceedings to test the validity or legality of their election. Under Section 42 of the Act we have ample authority to institute court proceedings to enjoin violations of Section 16(a) where necessary. We have not considered that any occasion exists calling for such action on our part with respect to SCG because, almost immediately after the Section 16(a) problem came to our attention, there was held a regular annual meeting of the SCG stockholders, and a board of directors was elected by the vote of stockholders in exact compliance with Section 16(a).[14]

Accordingly, we turn to a consideration of the various factors which we deem relevant to a determination of whether or not, in the exercise of our discretion and under the general standard of the public interest and the protection of investors, we should revoke our order exempting the Anemostat transaction.

At the outset we note that the failure to comply with Section 16(a) resulted from the fact that the new major

14. Nadler in his brief raises the question whether the six purchasers of DCA's majority block of SCG stock could have acted together to elect the same three persons as directors without being solicited to do so in violation of our proxy rules or pursuant to a fraudulent conspiracy. Aside from the fact that the validity of the election of directors at the annual stockholders' meeting in April 1960 is not in issue here, there is no evidence of any solicitation of proxies in violation of the proxy rules or of any fraud with respect to such meeting.

ity stockholders were ignorant of the provisions of that Section. This is not to say that their ignorance excuses the non-compliance; but in our opinion the inadvertent nature of the violation on the part of the major beneficial owners is a factor to consider in determining whether to revoke our order based on the application authorized by them.[15] It is also to be noted that prompt notice, although not in the form of an election at a stockholders' meeting as envisaged by Section 16(a), was given of the change in the management of SCG by the filing with us of ownership reports by DCA, Peddy, Henderson and Finkle, pursuant to Section 30(f) of the Act and Rule 30f-1 thereunder, which disclosed the sale by DCA of its holdings of SCG stock and the acquisition of SCG stock by Peddy, Henderson and Finkle and stated that the three individuals had become directors of SCG.

We also consider that substantial significance should properly be attached to the fact that we scrutinized the Anemostat transaction before it was consummated and reached the conclusion on the basis of the facts presented to us that the terms of the transaction were reasonable

15. The fact that the majority stockholders could have caused a stockholders' meeting to be held at which they could have elected the same directors by a stockholders' vote does not, of course, make Section 16(a) inapplicable. Nevertheless, it is clear that the principal objections to shifts in control without notice to and a vote of stockholders arise where the result is to deprive the beneficial owners of any voice in the conduct of the management, where the insiders who arrange a shift in control do not own the requisite amount of voting shares necessary to effect a change in management at an annual or special meeting of security holders, or where such insiders have no investment of their own or only a very small investment in the company. See Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies, Part Three, pp. 1874, 1878 (1940). None of such conditions existed here.

and fair and did not involve overreaching. Although at the time those findings were made we were not aware of the non-compliance with Section 1(c)(1), it does not appear that a more thorough scrutiny of the proposed transaction would have been undertaken or a different conclusion reached had we been aware of that fact. Absent a showing that material facts were withheld from us or that there was fraud in other respects in the submission of the application for exemption, we see no basis for a reconsideration of our previous conclusions. Our examination of the record in the instant proceedings, which explored the circumstances surrounding the sale of DCA's holdings of SCG stock and the Anemostat transaction, indicates that no such showing has been made.

It was known to us that the Anemostat transaction was entered into on behalf of SCG by persons who had just acquired their shares of SCG stock from DCA and had just become directors of SCG. The ownership reports by DCA, Peddy, Finkle and Henderson, previously referred to, disclosing DCA's sale of its SCG common stock as well as the fact that Peddy, Finkle and Henderson had purchased 75,000 shares of such stock and had become directors of SCG, had been filed with us prior to the time the application was filed. The public notice issued by us with respect to the filing of the application, and the order granting the exemption, both referred to the prior recent sale by DCA of its controlling interest in SCG.[16]

Furthermore, there is no evidence that the sale of the SCG stock by DCA was conditioned upon a sale of the

16. Investment Company Act Release No. 2948, p. 2 (December 16, 1959); Investment Company Act Release No. 2958, p. 2 (December 30, 1959).

Anemostat stock to DCA, or that the purchasers of the SCG stock were permitted to purchase such stock at a low price and in return therefor agreed to sell the Anemostat stock to DCA at a low price. Indeed, it seems unquestioned that the purchasers agreed to purchase the SCG stock from DCA without any knowledge on their part of the possibility of a subsequent transaction respecting the Anemostat stock. Moreover, the record shows that Peddy, Henderson and Finkle were persons of considerable substance with diverse business interests. While they apparently respected DCA's president, Raymond F. Kelley, and relied on his integrity, they exercised independent judgment in negotiating the Anemostat transaction, as is evidenced by the fact that Peddy on behalf of SCG rejected DCA's original proposal involving an even exchange of the Anemostat stock for the SCG preferred stock held by DCA and insisted on a cash payment in addition to the preferred stock."

On the basis of the record made in the instant proceedings, instituted specifically to determine whether our prior exemptive order should be revoked, we cannot find evidence of fraud or overreaching in the circumstances surrounding the negotiation of the Anemostat transaction and the submission to us of the application based thereon. While, as noted previously, Nadler's principal contention is that no showing of fraud is necessary where there has been a failure to comply with Section 16(a), he also con-

17. Nadler's theory seems to be that Kelley had DCA sell its SCG stock to persons who because of their experience or other interests would not be interested in active management of Anemostat and who would therefore be disposed to consider favorably a proposal to sell SCG's controlling interest in Anemostat. Even assuming that this is a plausible speculation as to the workings of Kelley's mind, it falls far short of evidence of fraud or collusion.

tends that the transaction was fraudulent and in this connection asserts that one cannot ignore the fact of close friendship between Kelley and some of the purchasers of the SCG stock. The transaction itself was reviewed by us in the prior proceedings, and the circumstances leading to the transaction, including the relationship of the purchasers to Kelley, were the subject of the instant proceedings. But we cannot find fraud or overreaching simply on the basis that the purchasers of the SCG stock were friends of Kelley or of his associates.

Nadler has also attacked the three appraisals which were before us when we found the consideration in the Anemostat transaction to be fair and reasonable; contending that such appraisals were not properly prepared, failed to consider certain factors and failed to give adequate weight to other factors in evaluating Anemostat as a going concern or on a liquidation basis, including the tax consequences of a sale of assets at a price below their book value. In view of our conclusion as to the limited significance of the Section 16(a) violation under the circumstances of this case, and the lack of evidence of fraud or overreaching, we find no basis for a re-examination of our findings with respect to fairness and reasonableness. Neither, in our opinion, is it appropriate to make our decision on whether or not our prior order should be revoked turn on whether at the present time SCG could obtain more or less for its Anemostat stock. As Nadler himself recognizes, the fairness of the transaction when made would not be affected by subsequent events.[18]

18. While we do not deem it necessary or appropriate to determine the consequences which might flow from a rescission of the Anemostat transaction, we note that DCA and SCG have incurred

Appendix A

CONCLUSIONS

We have found that the failure to comply with Section 16(a) was inadvertent; that since the purchasers of the SCG stock from DCA were the major beneficial owners of SCG they could have elected, and at the next regular meeting of stockholders did elect, their representatives as directors in compliance with the requirements of Section 16(a);[19] that there is no evidence to show that there was fraud or overreaching in the Anemostat transaction or

to various factors which indicate that such rescission would be detrimental to SCG. Thus, they point out that SCG, in compliance with the conditions of our exemption order, expended $103,187 to purchase publicly held preferred stock and to pay dividend arrearages on the preferred stock still outstanding, and assert that in the event of a rescission SCG could not recoup these funds but would be required to refund the cash consideration of $155,820 paid by DCA for the Anemostat shares. They further assert that in the event of rescission, SCG would either have to sell the Anemostat stock under less favorable circumstances, or would have to obtain funds to supply Anemostat with needed capital. In this connection, they point out that following consummation of the transaction it was learned that a portion of the plant leased by Anemostat would be taken by eminent domain early in 1961, and that consequently it might be necessary to move the company to a different location, entailing considerable financial and other problems. They also assert that competition in Anemostat's field has become increasingly intense and they point out that Anemostat's earnings for the first 4 months of 1960 were sharply reduced as compared to earnings during the same period in 1959. Finally, DCA and SCG point out that, if the Anemostat transaction were rescinded, SCG would lose the tax saving, assertedly amounting to from $34,500 to $49,500, which was obtained by concluding the transaction in 1959, before a large tax loss carry-forward expired. Nadler, on the other hand, contends that some of these problems are not as serious as SCG and DCA represent, and that the tax savings are not as large as claimed and would be more than offset by potential tax carry-back benefits.

19 As previously noted, at the annual stockholders' meeting in April 1960, the majority stockholders also voted to ratify the prior acts of directors and officers.

in the submission to us of the application for exemption; that we examined the proposal to sell the Anemostat stock before the transaction was completed and issued an order in which we found, among other things, that the terms thereof, including the consideration to be paid, were reasonable and fair and did not involve overreaching on the part of any person concerned; and that following the issuance of our order and in accordance therewith the parties thereto consummated the transaction. Under all the circumstances we conclude that there is no basis for revoking our prior exemption order.

PROCEDURAL MATTERS

The Division filed a brief recommending that the prior order of exemption not be revoked. At the oral argument, however, the Division requested that the record be reopened for the limited purpose of receiving additional evidence regarding the possibilities of SCG's realizing more than was paid by DCA.[20] In view of our determination herein with respect to the prior order of exemption, no purpose would be served by a reopening of the record for this purpose and accordingly we deny the Division's request.

Nadler and the other stockholders of SCG associated with him requested that they be made parties to these proceedings. At the hearings, the hearing examiner, pursuant to Rule XVII (now Rule 9 (17 CFR 201.9)) of our Rules of Practice, granted them leave to be heard and

20. In this connection the Division suggested further exploration of a contention that a sale of Anemostat's assets would be more advantageous to SCG than a sale of the stock, and also exploration of the extent to which Anemostat will incur expense as a result of the condemnation of an important part of the plant it leases.

to participate in the proceedings with the same rights as those of a party, except the right to determine the post-hearing procedures. Counsel for Nadler and the other stockholders has introduced evidence, including depositions of certain witnesses, cross-examined witnesses, filed a brief and a reply brief and participated in the oral argument. There has been no showing and no assertion that the leave to be heard was in any way inadequate to protect Nadler's interests or those of the stockholders associated with him. Under these circumstances, and in the light of the provision of Rule XVII that no person shall be admitted as a party to a proceeding unless we are satisfied, among other things, that leave to be heard would be inadequate for the protection of his interests, we see no basis for granting the requests and they are accordingly denied.

An appropriate order discontinuing these proceedings will issue.

By the Commission (Chairman Gadsby and Commissioners Hastings and Woodside), Commissioner McCauley not participating.

Orval L. DuBois
Secretary

Appendix A

Order Exempting Transaction Between Affiliates and Permitting Closed-End Investment Company to Acquire Preferred Stock Issued By It

UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

December 30, 1959.

In the Matter of

SECURITIES CORPORATION GENERAL

File No. 812—1273

Investment Company Act of 1940

Securities Corporation General ("SCG"), a registered closed-end, non-diversified investment company, having filed an application under Section 17(b) of the Investment Company Act of 1940 (the "Act") for an order exempting from the provisions of Section 17(a) of the Act the proposed acquisition by Dynamics Corporation of America ("DCA") from SCG of a total 77,395 shares of the common stock of Anemostat Corporation of America ("Anemostat") by (a) the proposed purchase of 56,195 of such shares in exchange for the transfer by DCA to SCG of a total of 4,757 shares of SCG preferred stocks (consisting of 1,219 shares and 3,538 shares, respectively, of SCG $7 preferred stock and SCG $6 preferred stock), and (b) the proposed purchase of 21,200 shares of such common stock in consideration of a cash payment of $155,820 by DCA to SCG;

Appendix A

The application filed by SCG having also requested an order pursuant to Section 23(c)(3) of the Act permitting SCG to purchase from DCA the 4,757 shares of SCG preferred stocks which DCA proposes to transfer to SCG as set forth in item (a) above:

The requests of SCG being based upon the following representations and information contained in its application:

SCG, organized in 1912 under the laws of Virginia, has outstanding 272,500 shares of $1 par value common stock, 4,731 shares of $6 series preferred stock and 1,843 shares of $7 series preferred stock. DCA owns 3,538 shares and 1,219 shares of SCG's $6 series and $7 series preferred stocks, respectively, or 74.78% and 66.14%, respectively, of the total amount of such stocks outstanding. The balance of SCG outstanding preferred stocks, consisting of 1,193 and 624 shares of the $6 series and $7 series, respectively, is publicly held.

The $6 series and $7 series preferred stocks of SCG are entitled to cumulative annual dividends (without preference of either series over the other) before dividends may be paid on the common stock. Such preferred stocks irrespective of series, have preference in the event of liquidation (whether voluntary or involuntary) of $100 a share plus accrued unpaid dividends and are redeemable at the company's option, in whole or in part, at $110 per share for the $6 series and $115 per share for the $7 series, plus accrued unpaid dividends applicable to the particular series.

At December 31, 1959, accrued dividend arrears will amount to $12 a share on the $6 series stock and $14 a share on the $7 series stock.

Appendix A

SCG has made a commitment that within 60 days following the consummation of the proposed transactions, it will invite the holders of its $6 and $7 series preferred stocks which then remain outstanding to tender their holdings of such stocks during a 30 day period for repurchase by SCG at prices of $93 a share for the $6 series and $99 a share for the $7 series.

SCG has also represented in its application that within 60 days after the expiration of the tender period it intends to pay all accrued dividend arrears on any shares of the $6 and $7 series stocks which have not been repurchased and remain outstanding; and that it would thereafter place both classes of its preferred stocks on a current dividend-paying basis to the extent permitted by law.

The assets of SCG, except for a relatively small amount of cash and minor miscellaneous assets, consist of 131,355 shares of the common stock of DCA or 4.95% of DCA's outstanding common stock and 77,395 shares of the common stock of Anemostat or 51.25% of Anemostat's total outstanding common stock. DCA owns 49,636½ shares of the common stock of Anemostat or 32.87% of the total amount of such stock outstanding.

DCA is engaged, directly and through wholly owned subsidiaries, in the business of manufacturing specialized and general electronics products, communications equipment, electrical appliances, quartz crystals and small motors. Anemostat's principal business is the manufacture of air diffusing equipment and related equipment for air conditioning systems.

The Commission's files show that until November 10, 1959, DCA controlled SCG through ownership of 150,593

shares of the latter's common stock or about 55% of the total amount of such stock outstanding; and that on such date DCA disposed of its entire investment in the common stock of SCG.

Pursuant to the definition contained in Section 2(a)(3) of the Act, DCA is an affiliated person of Anemostat and Anemostat, in turn, is an affiliated person of SCG. Generally speaking, Section 17(a) of the Act prohibits an affiliated person (DCA) of an affiliated person (Anemostat) of a registered investment company (SCG) from purchasing from such registered company (SCG) any security of which the seller is not the issuer (stock of Anemostat), unless the Commission by order upon application pursuant to Section 17(b) of the Act grants an exemption from Section 17(a) of the Act, upon a finding that the terms of the proposed transaction, including the consideration to be paid or received are reasonable and fair and do not involve overreaching on the part of any person concerned; and that the proposed transaction is consistent with the policy of the investment company concerned, and consistent with the general purposes of the Act.

Section 23(c)(3) of the Act prohibits a registered investment company from purchasing its own securities other than on a securities exchange or pursuant to tenders, except under such circumstances as the Commission may permit by order to insure that such purchases are made in a manner or on a basis which does not unfairly discriminate against any holders of the class of securities to be purchased. Since the proposed purchase by SCG from DCA of the 4,757 shares of SCG preferred stocks does not

involve purchase on a securities exchange or pursuant to tenders, such purchase is prohibited unless the Commission issues its order permitting it.

SCG acquired the shares of Anemostat common stock proposed to be sold to DCA during the period 1945-1947 at an average cost of about $6.34 a share. The book value of Anemostat's common stock was equal to about $12.16 a share at December 31, 1958. For the year ended December 31, 1958, net income of Anemostat was equivalent to $.59 a share on its outstanding common stock. For each of the five years 1954-1958, inclusive, Anemostat's net income per share of common stock was equal to $.54, $.49, $.75, $.76, and $.59, respectively, and averaged about $.62½ annually.

There are attached to the application three reports each of which SCG states was made by an investment firm "after independent" analysis of Anemostat. Two of these reports were prepared for DCA and the other for SCG. The going concern value of Anemostat common stock expressed in these reports ranges from $4.25 to $6.00 a share; on the assumption of liquidation of Anemostat by a controlling interest, one report states that such stock has a value of $6.51 a share, while another report concludes the value on such basis to be "$7 a share or better."

The application states that the terms of the proposed transactions are fair. The $155,820 of cash proposed to be paid by DCA to SCG for 24,200 shares of Anemostat common stock equates to about $7.35 a share of such stock as compared with the appraisal values discussed hereinabove. The application also states that the proposed transfer by DCA of its holdings of 4,757 shares of SCG preferred stocks to SCG in exchange for the latter's

holdings of 56,195 shares of Anemostat common stock is fair to SCG and its stockholders, because in return for Anemostat common stock with an assumed value of $413,633 (calculated at $7.35 a share) SCG will be relieved of obligations with respect to preferred stocks having a total par value and accrued arrears (at December 31, 1959) aggregating $535,222.

The application also states that SCG will benefit by the disposition of its investment in Anemostat because SCG is not currently obtaining a favorable return thereon; and SCG's primary function is investing and trading in securities rather than industrial management.

It is stated that the proposed transaction will benefit DCA by providing it with a subsidiary whose business is closely allied with that of DCA; and by enabling DCA to dispose of SCG's preferred stocks which presently serve no useful business purpose of DCA.

SCG states that its proposed acquisition from DCA of SCG preferred stocks does not unfairly discriminate against any holders of such class of stocks in view of the reasonableness of the consideration to be paid by DCA for the Anemostat stock and in view of the opportunity to be accorded public holders of SCG preferred stocks to tender their holdings thereof for repurchase by SCG as described hereinabove.

Due notice of said filing having been given in the form and manner prescribed in Rule 0-5 under the Act (Investment Company Act Release No. 2948); a request for a hearing having been received and subsequently withdrawn and the Commission not having received any other request for a hearing within the period specified in said notice or otherwise; and the Commission not having ordered a hearing on said application; and

Appendix A

The Commission having considered the matter and finding that the granting of the requested exemption from the provisions of Section 17(b) of the Act in respect of the proposed acquisition by DCA of the 77,395 shares of common stock of Anemostat is consistent with the policy of SCG and with the general purposes of the Act and that the terms of the proposed transaction, including the consideration to be paid are reasonable and fair and do not involve overreaching on the part of any person concerned; and the Commission also finding that the proposed purchase by SCG of 4,757 shares of SCG preferred stock would be made in a manner or on a basis which does not unfairly discriminate against any holders of the preferred stocks and, accordingly, that the request for an order pursuant to Section 23(c) of the Act should be granted.

It Is Ordered that the proposed acquisition by DCA, as set forth in the application, be, and the same hereby is, exempted from the provisions of Section 17(a) of the Act, pursuant to the provisions of Section 17(b) of the Act; and that the application of SCG for an order under Section 23(c) of the Act permitting SCG to purchase SCG preferred stock, as set forth in the application, be, and the same hereby is, granted forthwith, provided, however, that SCG shall carry out its commitment with respect to the invitation for tenders of its preferred stocks, the elimination of arrears thereon, and the payment of current dividend requirements on the preferred stock, as set forth in the application.

By the Commission.

Orval L. DuBois
Secretary

APPENDIX B

The Statute Involved
Investment Company Act of 1940

(United States Code, Title 15, Sections 80a-1—80a-52)

* * * *

SEC. 1. (b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * * * *

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * * * *

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

* * * * *

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this

section which adversely affect the national public interest and the interest of the investors.

• • • • •

SEC. 16. (a) No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting. In the event that at any time less than a majority of the directors of such company holding office at that time were so elected by the holders of the outstanding voting securities, the board of directors or proper officer of such company shall forthwith cause to be held as promptly as possible and in any event within sixty days a meeting of such holders for the purpose of electing directors to fill any existing vacancies in the board of directors unless the Commission shall by order extend such period. The foregoing provisions of this subsection shall not apply to members of an advisory board.

• • • • •

SEC. 17. (a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12 (d) (3) (A) and (B)), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

• • • • •

(2) knowingly to purchase from such registered company, or from any company controlled by such

registered company, any security or other property (except securities of which the seller is the issuer); or

* * * * *

(b) Notwithstanding subsection (a), any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of that subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve over-reaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this title; and

(3) the proposed transaction is consistent with the general purposes of this title.

* * * * *

SEC. 23. (c) No registered closed-end company shall purchase any securities of any class of which it is the issuer except—

(1) on a securities exchange or such other open market as the Commission may designate by rules and regulations or orders: *Provided*, That if such securities are stock, such registered company shall, within the preceding six months, have informed stockholders of its intention to purchase stock of such class by letter or report addressed to stockholders of such class; or

(2) pursuant to tenders, after reasonable opportunity to submit tenders given to all holders of securities of the class to be purchased; or

(3) under such other circumstances as the Commission may permit by rules and regulations or orders for the protection of investors in order to insure that such purchases are made in a manner or on a basis which does not unfairly discriminate against any holders of the class or classes of securities to be purchased.

* * * * *

SEC. 43. (a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the circuit court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission or any officer thereof designated by the Commission for that purpose, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure so to do. The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If application is made to the court for leave to adduce additional evidence, and if is shown to the satisfaction of the court that such additional evidence is material and that there were reasonable

grounds for failure to adduce such evidence in the proceeding before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

* * * * *

SEC. 44. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 34, or upon a failure to file a report or other document required to be filed under this title, may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this title or rules, regulations, or orders thereunder,

may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended. (U. S. C., title 28, secs. 225 and 347).

* * * * *

SEC. 47. (b) Every contract made in violation of any provision of this title or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation, or order.

* * * * *

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IN THE

Supreme Court of the United States

OCTOBER TERM 1961

No. 711

AARON M. NADLER,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION
Respondent,

SECURITIES CORPORATION GENERAL,
Intervenor,

DYNAMICS CORPORATION OF AMERICA,
Intervenor,

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR INTERVENOR, SECURITIES CORPORATION GENERAL, IN OPPOSITION

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INDEX

	PAGE
The Opinions Below	1
Jurisdiction	2
Question Presented	2
The Statute Involved	3
Statement of the Case	3
Argument	6
Conclusion	9

CITATIONS

Cases:

American Power and Light Company v. *SEC*, 141 F. 2d 606, affirmed, 239 U. S. 90	8
Brouk v. *Managed Funds, Inc.*, 286 F. 2d 901 (8th Cir.); cert. granted 366 U. S. 958	8, 9
Brown v. *Bullock*, 294 F. 2d 415 (C.A. 2, 1961)	9
Hennesey v. *SEC*, 285 F. 2d 511 (C.A. 3, 1961)	7
Nadler v. *SEC*, 296 F. 2d 63 (C.A. 2, 1961)	1

Statutes:

Investment Company Act of 1940, 15 U.S.C. §§80a-1–80a-52	
§16(a), 15 U.S.C. §80a-16(a)	2 and generally
§17(a), 15 U.S.C. §80a-17(a)	2
§17(b), 15 U.S.C. §80a-17(b)	5, 6
§23(b), 15 U.S.C. §80a-23(b)	2
§23(c), 15 U.S.C. §80a-23(c)	5, 6
§43, 15 U.S.C. §80a-42(a)	2
Judiciary and Judicial Procedure Act, 28 U.S.C. §1254 (1)	2
Virginia Code Annotated, §13.1-38	4

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BRIEF FOR INTERVENOR, SECURITIES CORPORATION GENERAL, IN OPPOSITION

The Opinions Below

The opinion of the Court of Appeals (Petition, App. A, pp. 27 to 30) is reported at 296 F. 2d 63 (C.A. 2, 1961).

The Findings and Opinion of the Securities and Exchange Commission dated December 23, 1960 (Investment Company Act Release No. 3165) are unreported and are printed in petitioner's App. A at pp. 32 to 50.

The order of the Securities and Exchange Commission dated December 30, 1959 (Investment Company Act Release

No. 2958) is unreported and is printed in petitioner's App. A. at pp. 51 to 57.

Jurisdiction

The order of the Court of Appeals was entered on November 14, 1961. The petition for a writ of certiorari was filed on February 8, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) and under 15 U.S.C. §80a-42(a).

Question Presented

Upon the application of Securities Corporation General ("SCG"), a registered investment company, the Securities and Exchange Commission ("Commission") entered an order exempting certain proposed transactions of SCG from the provisions of Sections 17(a) and 23(b) of the Investment Company Act of 1940 (the "Act"). Subsequently, it was discovered that the Board of Directors of SCG, at the time the application for exemption was made and the exemption was granted, was not constituted in accordance with Section 16(a) of the Act. The Commission thereupon instituted a proceeding to determine whether its exemption order should be revoked. After a lengthy hearing, the Commission concluded there was no basis for the revocation of the exemption order and that determination was affirmed by the court below.

Although the petition claims that several questions are presented, we believe that the only question raised by the petition is as follows:

Does the fact that the Board of Directors was not constituted in accordance with Section 16(a) make void, as a matter of law, the exemption order of the Commission, notwithstanding that the Board was properly constituted under state law, and notwithstanding that the Commission found that the exempted transactions were fair and reasonable and did not involve fraud or overreaching on the part of any one concerned?

The Statute Involved

Section 16(a) of the Investment Company Act of 1940 is set forth in Appendix B to the petition.

Statement of the Case*

SCG is a registered closed-end, non-diversified investment company, incorporated under the laws of the State of Virginia. Dynamics Corporation of America (DCA) is a corporation engaged in the manufacture of electronic and related products. Anemostat Corporation of America (Anemostat) is a corporation engaged in the manufacture of various equipment for air-conditioning systems.

Prior to October 1959, DCA controlled SCG through the ownership of the majority of the common stock of that company; it also owned the majority of SCG's preferred stock. In addition, DCA owned about 33% of Anemostat's common stock. At that time, the principal assets of SCG consisted of about 5% of DCA's common stock and 51% of Anemostat's common stock.

In order to eliminate the circular ownership outlined above and for other reasons, DCA sought to dispose of its holdings in SCG (R. 851, 1481, 1492) and also desired to acquire SCG's block of Anemostat common stock (R. 797-799).

Upon consulting legal counsel, DCA was advised that it could sell the SCG common stock owned by it to a limited number of persons, by means of a "private offering," without registration under the Securities Act of 1933. It was also advised that, after such a sale, it could negotiate with SCG for the purchase of the Anemostat stock owned by SCG. However, counsel stipulated that the offer to sell the

* Except where a different reference is noted, the facts set forth herein are those found by the Commission in its Findings and Opinion (Investment Company Act Release No. 3165) set forth at petitioner's App. A, pp. 32-50. "(R.)" refers to the record certified by the Commission to the Court of Appeals.

SCG stock could not be conditioned upon an understanding that the purchaser would thereafter cause the sale of the Anemostat stock to DCA (R. 797-799).

Acting upon this advice, DCA sold its holdings in SCG to five individuals and a corporation of which one of the individuals was general manager (R. 1479-83, 1484-86, 1487-89, 1492).

After completion of this sale, the six purchasers, who then owned a majority of the SCG common stock, requested that a director's meeting be called for the purpose of electing new officers and directors (R. 1525-1527). The SCG Board met on November 11, 1959, at which time the then incumbent directors resigned seriatim and elected three of the purchasers to fill their places. The new Board then appointed new officers. This election, although held in compliance with the laws of Virginia (Va. Code Ann. §13.1-38) and the by-laws of SCG, did not comply (except for the election of one of the three new directors) with Section 16(a) of the Act.

Reports of the election of the new directors and of the above sale were promptly filed with the Commission by DCA and the new directors.

At the same meeting, the new directors considered (and rejected) an offer made by DCA to exchange its holdings of SCG preferred stock plus accumulated dividends for the latter's Anemostat stock. Following negotiations, which were accelerated because of the impending expiration of substantial income tax loss carry-overs (R. 803-804), an agreement was reached, pursuant to which SCG agreed to sell to DCA all its common stock of Anemostat in exchange for all the preferred stock of SCG held by DCA plus approximately $156,000 in cash.*

At this point, the parties to the transaction learned for the first time that, contrary to the advice given earlier by

* This transaction was subsequently ratified at a regular meeting of the stockholders of SCG held on April 13, 1960. At that meeting, the same directors were re-elected for a further term.

DCA's counsel, it would be necessary to secure an exemption from the Commission under §§17(b) and 23(c) of the Act. Following an informal conference with the Commission staff, an application for such exemption was filed, and notice, as required by the Act, was given. On December 30, 1959, the Commission entered its order exempting the transaction and the transaction was consummated the following day. As required by the Act, the Commission expressly found that the sale of the Anemostat stock to DCA was consistent with the investment policy of SCG and with the general purposes of the Act and that "the terms of the proposed transaction including the consideration to be paid, are reasonable and fair and do not involve overreaching on the part of any person concerned."

Subsequently, the Commission, after an investigation initiated by petitioner's complaint, ordered a hearing to determine whether its order of exemption should be revoked because of the non-compliance with the requirements of Section 16(a) of the Act. Notice of that hearing was given to all shareholders of SCG. At that hearing, which dealt extensively with the fairness of the SCG-DCA transaction, some 1,300 pages of testimony were taken and some 90 documents were introduced. The hearing, in which petitioner participated, was followed by briefs and oral argument before the Commission itself. On the basis of that hearing and argument the Commission concluded:

> "We have found that the failure to comply with Section 16(a) was inadvertent; that since the purchasers of the SCG stock from DCA were the major beneficial owners of SCG they could have elected, and at the next regular meeting of stockholders did elect, their representatives as directors in compliance with the requirements of Section 16(a); that there is no evidence to show that there was fraud or overreaching in the Anemostat transaction or in the submission to us of the application for exemption; that we examined the proposal to sell the Anemostat stock before the

transaction was completed and issued an order in which we found, among other things, that the terms thereof, including the consideration to be paid, were reasonable and fair and did not involve overreaching on the part of any person concerned; and that following the issuance of our order and in accordance therewith the parties thereto consummated the transaction. Under all the circumstances we conclude that there is no basis for revoking our prior exemption order." (App. A, pp. 48-49).

Thereafter, petitioner filed a petition with the Court of Appeals for the Second Circuit to review the original order of the Commission and the Commission's refusal to revoke that order. On consent of all parties, DCA and SCG were granted leave to intervene. The Court below upheld the Commission's action.

Argument

A. Petitioner's ultimate objective is to set aside the sale of Anemostat stock by SCG to DCA, and the simultaneous purchase by SCG of its own preferred stock from DCA. These transactions were consummated pursuant to exemptions granted by the Commission under Sections 17(b) and 23(c) of the Act. In granting those exemptions, the Commission found that the transactions were "fair and reasonable and did not involve overreaching." That finding was reaffirmed by the Commission after a lengthy hearing and was upheld by the Court below. It may not be challenged here.

Petitioner challenges the transactions—and the Commission's exemption of the transactions—on the ground that the Board of Directors of SCG had not been elected in compliance with Section 16(a) of the Act, and that the actions of that Board are void. The question whether Section 16(a) of the Act makes void the transactions of the Corporation and the exemption by the Commission is the only

question presented by the petition. This question is, as petitioner claims, one of first impression. There is no conflict calling for resolution by this Court. Moreover, the decision below is in all respects correct.

The short answer to the contention of petitioner was given by the Court below:

> "We see no basis for the conclusion that all acts by a board not chosen as required by §16(a) must be considered void. The statute indicates that such a board has power to take action to secure a properly chosen board within a sixty-day period, which may be extended by the Commission. It would be an unsound policy, fraught with harm to the shareholders, to have everything done by such a board to carry on the corporation's normal business, especially within the statutory period, declared invalid. The Commission acted properly in carefully scrutinizing transactions during the interim period and in not voiding transactions found to be reasonable and proper in themselves."

This approach does not render Section 16(a) "meaningless and a dead letter" as petitioner argues (Petition, p. 10). The Commission has at its command a full arsenal of weapons to deal with Section 16(a) violations, including the power, if it sees fit, to revoke orders procured by persons not elected in compliance with its terms, to enjoin violations of the Act, and to proceed criminally against willful violators of the Act. As the Commission itself states:

> "This conclusion is not contrary to the provisions of Section 16(a) or of any other section of the Act, and it is consistent with the over-all purposes of the Act to serve the public interest and protect the interests of investors." * (Petition, App. A, pp. 42-43.)

* In addition, it has been held that the Commission has the authority to retroactively excuse a violation of the Act. *Hennessey* v. *SEC*, 285 F. 2d 511, (C.A. 3, 1961).

The interpretation by the Comimssion is entitled to great weight (*American Power and Light Company v. SEC*, 141 F. 2d 606, affirmed, 239 U.S. 90) and is determinative against petitioner's claim that the construction given Section 16(a) by the Court of Appeals defeats the purpose of that section and is contrary to the administrative interpretation thereof by the Commission.

It is clear, therefore, that no matter how viewed, the violation of Section 16(a) of the Act, at most, made the exemption subject to revocation and did not make such revocation mandatory. The determination to this effect by the Court of Appeals is correct.

B. Petitioner devotes approximately two-thirds of his brief (Points II and III) to arguing the proposition that a "public stockholder" has an independent right to seek a declaration that a transaction in violation of the Act is void, and that petitioner has been deprived of that right by the decision below. We simply do not understand this argument.

Petitioner, on April 1, 1960, commenced an action in the U. S. District Court for the Southern District of New York seeking to set aside the transaction between SCG and DCA. In that action, neither petitioner's power to bring the suit nor the jurisdiction of the District Court was ever questioned. Subsequently, as he admits (Petition, p. 9), petitioner entered into a stipulation providing for the dismissal of the District Court action if the order of the Commission, which is the subject of this petition, was finally sustained. It is that stipulation, voluntarily made by petitioner, rather than the decision of any court, which precludes the petitioner from prosecuting an independent action. Petitioner may now regret having entered into the stipulation, but we cannot see why this Court should entertain petitioner's collateral attack on his own stipulation.

So too, petitioner's desperate attempt to make capital of this Court's grant of certiorari in *Brouk v. Managed Funds, Inc.*, 286 F. 2d 901 (8th Cir.), cert. granted 366 U.S.

958, is completely devoid of merit. This case and the *Managed Funds* case both involve an interpretation of the Investment Company Act of 1940. Beyond that, the cases have nothing to do with each other. The question in the *Managed Funds* case (and in *Brown v. Bullock*, 294 F. 2d 415 [2nd Cir., 1961]) was whether the Act creates a federal cause of action by a stockholder, derivatively, or in his own right, to sue directors for alleged violations of the Act. The sole question there involved is whether, in the absence of diversity, the federal courts have jurisdiction over such a suit. The question of jurisdiction has never been raised in this case; petitioner had an opportunity in the federal court to try any issues he wished to try. However, he stipulated to waive that opportunity and to let his case stand or fall on the decision on the appeal from the Commission's order. That question was decided correctly below and there is nothing more for this Court to do.

Conclusion

For the reasons set forth above, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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March 7, 1962

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No. 711

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

AARON M. NADLER,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent,

SECURITIES CORPORATION GENERAL,
Intervenor,

DYNAMICS CORPORATION OF AMERICA,
Intervenor.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR INTERVENOR DYNAMICS CORPORATION OF AMERICA IN OPPOSITION

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March 9, 1962

INDEX

OPINIONS BELOW .....

JURISDICTION .....

QUESTION PRESENTED .....

STATUTE INVOLVED .....

STATEMENT OF THE CASE .....

ARGUMENT .....

CONCLUSION .....

TABLE OF CITATIONS

STATUTES:

Investment Company Act of 1940, 15 U
§§ 80a-1—80a-52:

Section 2(a)(3) .....

Section 6(c) .....

Section 16(a) .....

Section 17(a) .....

Section 17(b) .....

Section 23(c) .....

Cases

Bailey, Hugh B., 28 S. E. C. 202 (1948)

Fennit v. Managed Funds, Inc., 206 F. 2d

Cir.), cert. granted, 346 U. S. 868 (19

Fenner v. Bullock, 206 F. 2d 405 (6th Cir.

Gruber v. Keystone Corp., 28 S. E. C. 155

Hannegan v. Sec'y, 206 F. 2d 48 (3d Cir.

Transit Investment Corp., 28 S. E. C. 10

MISCELLANEOUS:

Jaretski, *The Investment Company Act of 19*
Wash. U. L. Q. 303 (1941) .....

Securities and Exchange Commission, Inves
Company Act Releases:

No. 2365—Scudder Special Fund, Inc.
5, 1956) .....

No. 2710—The One William Street Fun
(May 8, 1958) .....

No. 3053—Naess & Thomas Special Fun
(June 23, 1960) .....

No. 3272—Centennial Fund II, Inc. (Ju
1961) .....

PAGE

, 26
.... 7
nent
June
.... 8
Inc.
.... 8
Inc.
.... 8
e 13.
.... 8

IN THE

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AARON M. NADLER,
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SECURITIES AND EXCHANGE COMMISSION,
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ON PETITION FOR A WRIT OF CERTIORARI TO T
STATES COURT OF APPEALS FOR THE SECOND

BRIEF FOR INTERVENOR DYNAM CORPORATION OF AMERICA IN OPPO

Opinions Below

The opinion of the United States Court of the Second Circuit is reported at 296 F. 2d 6 forth in the petition at pp. 27-30. The findings orders of the Securities and Exchange Commis forth in the petition at pp. 30-57.

Jurisdiction

The jurisdictional requisites are adequately set forth in the petition.

Question Presented

Does an inadvertent failure by a registered investment company to comply with the director election provision of Section 16(a) of the Investment Company Act of 1940 render void, rather than voidable, either

(1) a transaction found by the Commission to be non-discriminatory, fair and reasonable, consistent with the investment policy of the company and consistent with the purposes of the Act, or

(2) the application by the company to the Commission for an exemption for such transaction pursuant to Sections 17(b) and 23(c) of the Act, or

(3) an order of the Commission so exempting such transaction?

Statute Involved

In addition to the sections of the Investment Company Act of 1940 printed in the petition at pp. 58-63, Section 6(c) of that Act is also pertinent:

> "Sec. 6. (c) The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection

of investors and the purposes fairly intended by the policy and provisions of this title."*

Statement of the Case

Late in 1959 Securities Corporation General, a registered investment company incorporated under the laws of Virginia (hereinafter called SCG), negotiated an agreement to sell 77,395 shares of Common Stock of Anemostat Corporation of America (hereinafter called Anemostat) to Dynamics Corporation of America (hereinafter called Dynamics), in exchange for $155,820 in cash and 4,757 shares of SCG Preferred Stock. The agreement was made subject to issuance of an exemption order by the Securities and Exchange Commission (hereinafter called the Commission) under the Investment Company Act of 1940 (hereinafter sometimes called the Act) because Dynamics was an "affiliated person" of an "affiliated person" of SCG (Sections 17(a) and (b))** and because SCG would be acquiring its own stock (Section 23(c)). SCG applied for the requisite exemption order, the Commission gave the statutory notice to stockholders and, on December 30, 1959, after finding that the transaction was fair and reasonable and otherwise met the statutory standards of exemption, the Commission issued an order exempting the proposed transaction.

In May and June of 1960, having been informed by petitioner that the directors of SCG had been elected in violation of Section 16(a) of the Act (*i.e.*, seriatim

*When incorporated in the U. S. Code as 15 U. S. C. § 80a-6(c), Section 6(c) was expanded to accommodate amendments to the Bankruptcy Act appearing in other sections of the Investment Company Act of 1940.

**The affiliation between Dynamics and SCG was by virtue of common affiliation with Anemostat. See Section 2(a)(3) of the Act.

by incumbent directors rather than by the stockholders), the Commission conducted a public hearing to determine whether or not it should revoke its 1959 exemption order. Petitioner, SCG Dynamics and the Division of Corporate Regulation of the Commission participated in hearings before a trial examiner, compiling a record of almost 2,000 pages, and submitted briefs to and presented oral argument before the Commission. The Commission considered the facts with respect to the election of the SCG directors and concluded that the failure to comply with Section 16(a) had been inadvertent. The Commission noted that by then the stockholders had properly elected the same directors (their original election had been in compliance with Virginia law, but admittedly not with Section 16(a)) and had ratified the transaction in question. In addition, after petitioner had examined intervenors' officers at length and propounded the same unsupported allegations of misconduct alleged and insinuated without foundation in the petition to this Court, the Commission held that petitioner had failed to establish wrong-doing, fraud or overreaching, and that there was no basis for reversal of its earlier findings that the transaction was fair and reasonable, non-discriminatory, consistent with the investment policy of SCG and consistent with the general purposes of the Act. Therefore, in December 1960, the Commission issued findings and an opinion and entered an order discontinuing the proceedings, thereby leaving undisturbed the 1959 order.

The Second Circuit affirmed the Commission [illegible] and petitioner, seeking to set aside both the 1959 and the 1960 orders of the Commission, now petitions this Court for review that affirmance.

Argument

I.

THE INADVERTENT FAILURE TO COMPLY WITH SECTION 16(a) OF THE ACT DID NOT VOID EITHER THE TRANSACTION OR THE APPLICATION TO THE COMMISSION FOR AN EXEMPTION FOR THE TRANSACTION OR THE COMMISSION'S EXEMPTION ORDER.

Although petitioner's first three reasons for granting the writ ask the Court to construe Section 16(a), petitioner never comes to grips with the question presented by this case: does non-compliance with Section 16(a) render void or merely voidable a subsequent transaction or Commission exemption? Only if such transaction and exemption are void should the Court consider setting aside the orders of the Commission. If the transaction and exemption are merely voidable, the conclusions of the Commission after a full hearing—that the failure to comply was inadvertent, that the terms of the transaction were fair and reasonable and that there was no fraud or overreaching—should not be disturbed in the absence of an abuse of the Commission's discretion.

The Court of Appeals held that a transaction authorized by a board of directors not elected as required by Section 16(a) is not void. It noted the harm to stockholders which would flow from such an arbitrary rule—harm which the record shows would flow to the stockholders of both SCG and Dynamics were they required to unwind the transaction at issue—and held that an act by such a board is merely voidable. Thus, the court concluded, the Commission has discretion to decline to revoke its exemption for a particular transaction when that transaction is fair and reasonable. In the Court of Appeals petitioner urged repeatedly that the

Commission had no such discretion. Petitioner now has abandoned that basic position, seeking instead to confuse the issue by quibbling with the Second Circuit's reference to the statutory discretion to extend the period of time within which an incomplete board may arrange for a stockholders' meeting to complete the board.

Section 6(c) of the Act compels a conclusion quite contrary to petitioner's assertion that a transaction—any transaction—is void if authorized by a technically improperly elected board. That section grants the Commission the power

> "... conditionally or unconditionally [to] exempt any person, security, or transaction ... from any provision or provisions of this title ..., if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

The reason for the inclusion in the Act of such broad exemptive power is particularly important in the instant case. The Act was adopted as an affirmative means of controlling actual abuses in the investment company industry, not as a formally constructed trap for the unwary—a distinction evident from the pattern of the Act, which combines strict regulatory provisions with extremely broad exemptive powers lodged in the Commission as the regulatory agency. In the petition (pp. 13-14) petitioner cites the definitive article of Alfred Jaretski, Jr. to elucidate the underlying purpose of Section 16(a)—the prevention of serious infringement of shareholders' rights through unscrupulous inside manipulation. Later in the same article Mr. Jaretski points out that Section 16(a) and other provisions of the Act are moored to their substantive foundations by sweeping grants of exemptive power to the Commission:

> . . . Without these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive, and would cause unnecessary hardships." Jaretski, *The Investment Company Act of 1940*, 26 Wash. U. L. Q. 303, 344 (1941).

Thus, in determining that SCG's failure to comply with Section 16(a) merely rendered the 1959 order voidable rather than void, the Commission did no more than exercise its discretionary power to prevent an inadvertent error from causing an unreasonable hardship. The Commission found (i) that an election was held which, while it failed to comply with Section 16(a) because of a simple lack of familiarity with that Section of the Act, was in accord with the applicable state law and with the by-laws of the corporation; (ii) that the persons who caused the new directors to be elected held a majority of the outstanding shares and thus could easily have elected the same directors with the requisite formality of a shareholders' meeting; (iii) that the new directors, instead of concealing their election, filed reports of their stock ownership and assumption of office with the Commission; (iv) that the same directors had been subsequently re-elected and their acts ratified by a shareholder vote; (v) that despite the unintentional violation of Section 16(a), the application for the 1959 order was filed by a properly-elected president; (vi) that the transaction authorized by the 1959 order was negotiated at arm's length and in good faith; (vii) that such transaction was reasonable and fair and involved no overreaching; and (viii) that subsequent events showed that the timing of the Anemostat transaction benefited SCG whereas rescission would have been to its detriment. In the light of those facts, the Commission acted well within its discretionary power under Section 6(c) in refusing to revoke its 1959 order.

Reference to previous Commission decisions under Sections 6(c) will demonstrate that any other ruling in the present case would have been inconsistent both with prior Commission practice and with the substantive policies of the Act. *E.g., Transit Investment Corp.*, 28 S. E. C. 10 (1948); *Hugh B. Baker*, 24 S. E. C. 202 (1946). See *Graham-Newman Corp.*, 28 S. E. C. 133 (1948).

The granting of a retroactive exemption under Section 6(c) has received its most recent stamp of judicial approval in *Hennessey* v. *SEC*, 293 F. 2d 48 (3d Cir. 1961).

That the Commission's discretion under Section 6(c) extends to Section 16(a), as well as to all the other sections of the Act, seems clear from a long series of decisions under Section 6(c) expressly exempting investment companies in their organization stages from the shareholder vote requirements of Section 16(a). *E.g., Centennial Fund II, Inc.*, SEC Investment Co. Act Release No. 3272 (June 13, 1961); *Naess & Thomas Special Fund, Inc.*, SEC Investment Co. Act Release No. 3053 (June 23, 1960); *The One William Street Fund, Inc.*, SEC Investment Co. Act Release No. 2710 (May 8, 1958); *Scudder Special Fund, Inc.*, SEC Investment Co. Act Release No. 2365 (June 5, 1956).

In the present case, where the inadvertent violation of Section 16(a) is without relevance to the substantive fairness of the Anemostat transaction, petitioner is merely attempting to use a technical defect as a crowbar to force apart a transaction whose business justification he personally disputes. By refusing to revoke its 1959 order, the Commission did no more than implicitly exempt an inadvertent violation of Section 16(a) subsequently cured by an election of directors. Unless the Court believes, therefore, that the Commission has no discretion to exempt a fair and equitable transaction simply because it was authorized by a

board elected in inadvertent violation of Section 16(a), the petition is without merit.

II.

THE COURT OF APPEALS DID NOT HOLD THAT A STOCKHOLDER OF A REGISTERED INVESTMENT COMPANY HAS NO INDEPENDENT RIGHT TO ATTACK IN THE COURTS TRANSACTIONS IN VIOLATION OF THE ACT

The fourth and fifth reasons given by petitioner for granting certiorari (as well as the third, fourth and fifth of his "questions presented" and Point II of his petition) all proceed on the erroneous conclusion that the Court of Appeals held that a stockholder of a registered investment company does not have a right to attack directly in a Federal court a transaction allegedly in violation of the Act. Such a conclusion is utterly without foundation, either in the context of the petition to the Court of Appeals to review the Commission's orders or in the language of the decision of the Second Circuit itself. Whether or not such a right exists was not decided by the Commission, was not a relevant issue before the Court of Appeals (although raised by petitioner in his reply) and could not be decided in this proceeding.

The Court of Appeals did not pass upon the jurisdiction of a district court. The Court of Appeals concluded simply that the Commission acted within its power when it concluded that an exemption should not be withdrawn because of inadvertent non-compliance with Section 16(a) of the Act. Petitioner argues (p. 20) that the Commission does not have power to "void" a transaction because of a violation of Section 16(a), but certainly the Commission upon re-examination could have withdrawn its exemption had it found the transaction to be discriminatory, or unfair or unreasonable, or inconsistent with the investment policy of the

[illegible] investment company, or inconsistent with the purposes of the Act. A violation of Section 10(a) would be a relevant consideration in reaching any such conclusion, but the Commission concluded instead that the exemption should not be withdrawn because of the inadvertent violation.

There is, to be sure, a conflict in the circuits that exists between the decision of the Second Circuit in *Brown* v. *Bullock*, 294 F. 2d 415 (2d Cir. 1961), and the Eighth Circuit in *Brown* v. *Maryland Funds, Inc.*, 280 F. 2d 901 (8th Cir.), cert. granted, 366 U. S. 928 (1961). Parenthetically, however, it should be noted that the Second Circuit concluded that the stockholder does have an independent right of action. Doubtless the Second Circuit does not regard its *per curiam* opinion in this case as reversing its earlier decision in *Brown* v. *Bullock*, and petitioner's assertion that, in effect, it does is without merit. It is petitioner's voluntary consent to the dismissal with prejudice of his district court action, and not the decision of the Second Circuit in this case, which today prevents petitioner from making any further attack on the Commission's orders in the district court.

Petitioner's Point III, to the effect that he has been deprived of his day in court, is equally without merit. For the reasons stated above, clearly the Second Circuit has not held that petitioner has no right to a day in court. Indeed, the Court of Appeals observed that petitioner "was given a very full hearing", after which the Commission "made an extensive review of the evidence and found that there was no evidence of fraud or overreaching in the transaction and that the terms and considerations of the transaction were fair and reasonable. So it declined to revoke its exemption." 296 F. 2d at 64.

Notwithstanding, petitioner asserts that "there have never been any proceedings before the SEC for an order

exempting the transaction from Section 16(a) of the Act." (Petition, p. 28.) But as demonstrated at p. 7, *supra*, the Commission, in reviewing the transaction at length, considered all of the facts petitioner could adduce with respect to the Section 16(a) violation and concluded that it was inadvertent and had been subsequently cured. Hence, to remand this case now for a specific application to the Commission for exemption would be a meaningless gesture in the face of the Commission's clear determination that the transaction was properly exempted.

Conclusion

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted.

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March 9, 1962.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	2
Argument	9
Conclusion	13

CITATIONS

Cases:

Brouk v. *Managed Funds, Inc.*, 286 F. 2d 901, certiorari granted, 366 U.S. 958 12

Brown v. *Bullock*, 294 F. 2d 415 12

Goldstein v. *Groesbeck*, 142 F. 2d 422, certiorari denied, 323 U.S. 737 12

Graham-Newman Corp., 28 S.E.C. 133 10

Hennessey v. *Securities and Exchange Commission*, 293 F. 2d 48 11

In the Matter of Townsend Corp. of America, Townsend Management Co., Investment Company Act Releases No. 3288, 26 Fed. Reg. 6404 and No. 3296 (SEC File No. 812-1415) 11

Statute and Rules:

Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq:*

Section 6(c)	2, 11, 12
Section 16(a)	2, 3, 7, 8, 9, 10, 11, 12
Section 17(a)	2
Section 17(b)	2, 4, 6
Section 20(c)	3
Section 20(d)	3

634164—62——1

Statute and Rules—Continued

	Page
Investment Company Act of 1940—Continued	
Section 23(c)	2, 4, 6
Section 30(f)	4
Section 40	5
Section 47(b)	10
Rule 0–2, 17 C.F.R. 270.0–2	7
Rule 0–5, 17 C.F.R. 270.0–5	5
Rule 30f–1, 17 C.F.R. 270.30f–1	4
Miscellaneous:	
24 Fed. Reg. 10319	5
Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, Part 3, p. 1878 (1940)	10

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 711

AARON M. NADLER, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 27–30) is reported at 296 F. 2d 63. The findings and opinion of the Securities and Exchange Commission, dated December 23, 1960 (Pet. App. 32–50), have been published as Investment Company Act Release No. 3165.

JURISDICTION

The judgment of the court of appeals affirming the order of the Securities and Exchange Commission was entered on November 14, 1961 (Pet. App. 25–26). The petition for a writ of certiorari was filed on February 8, 1962. The jurisdiction of this Court is

invoked under Section 43(a) of the Investment Company Act of 1940, 15 U.S.C. 80a–42(a), and 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the Commission was justified in declining after a full hearing to revoke a prior exemption order under the Investment Company Act, which permitted an exchange of securities between a registered investment company and its affiliate found to be fair and reasonable, solely because the order had been obtained by the investment company at a time when its directors had inadvertently been chosen contrary to Section 16(a) of the Act.

STATUTE INVOLVED

Pertinent provisions of the Investment Company Act of 1940, 15 U.S.C. 80a–1 *et seq.*, are Sections 6(c), 16(a), 17 (a) and (b) and 23(c). Section 6(c) is set forth at page 11, *infra*. The remaining sections appear in the appendix to the petition (Pet. App. 59–61).

STATEMENT

This case involves the validity of a Commission order of December 23, 1960, which held that there was no basis for revoking a prior order dated December 30, 1959 (Pet. App. 51–57). The latter order granted exemption from provisions of the Investment Company Act of 1940 to permit Securities Corporation

General (SCG), a registered investment company, to engage in certain stock transactions with Dynamics Corporation of America (DCA), its affiliate.

Section 16(a) of the Investment Company Act of 1940 requires that directors of registered investment companies shall be elected by security holders at an annual or special meeting called for that purpose. Petitioner suggests that because SCG's board of directors had not been elected in the manner required by Section 16(a) at the time of the application, the order of December 30, 1959, was void when issued and should have been so held when the infirmity was brought to the Commission's attention.

Before October 1959, DCA, a company engaged in the manufacture of electronic and related products, controlled SCG through the ownership of about 55 percent of its outstanding common stock. SCG in turn held 51.25 percent of the outstanding common stock of Anemostat Corporation of America. The bulk of the remainder of Anemostat stock, 32.8 percent, was owned directly by DCA. SCG's principal assets consisted of its holdings of Anemostat plus 4.95 percent of DCA's outstanding common stock.

The cross-ownership of SCG and DCA stocks, which was contrary to the legislative policy reflected in Subsections (c) and (d) of Section 20 of the Act, was eliminated in October 1959, when DCA sold its SCG common stock to six persons in 25,000-share

blocks.[1] The Commission was promptly informed of the transaction through ownership reports filed by DCA and by the new purchasers pursuant to Section 30(f) of the Act and Rule 30f–1 thereunder. At a meeting of the purchasers on November 4, 1959, called by the president of DCA (App. 317, 318), a letter was sent to the then directors of SCG requesting that a directors' meeting be held for the purpose of replacing the existing board of directors (App. 233–234, 520), whose members were nominees of DCA. The directors' meeting was held on November 11, 1959, and the directors then in office resigned *seriatim*, electing as directors three of the purchasers.

Following the November 4 meeting, DCA's president inquired by letter whether SCG would be interested in selling its 51 percent holdings of Anemostat common stock in exchange for the SCG preferred stock owned by DCA (App. 523). After negotiations from November 4 to December 2, 1959, SCG and DCA reached an agreement (App. 262–263, 523–525). This resulted in the application, pursuant to Sections 17(b) and 23(c)(3) of the Act, filed December 11, 1959. With respect to the former section, the application sought an exemption in connection with DCA's acquisition from SCG of 77,395 shares of Anemostat common stock. With respect to the latter section,

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[1] On various occasions during the preceding several years DCA had been advised by the staff of the Commission that it should divest itself of SCG common stock (R. 548–549, 604; App. 309, 348).

"R. —" refers to the certified transcript of record filed with the court of appeals; "App. —" refers to the appendix to petitioner's brief filed in the court of appeals.

the application sought an order permitting SCG to receive 4,757 shares of its preferred stock, as well as $155,820 in cash, from DCA as consideration for SCG's Anemostat stock. Acting on the advice of tax counsel SCG represented to the Commission that there was need for haste since, if the transaction could be consummated before the close of the year, SCG would benefit from a substantial tax loss carry-forward which would otherwise expire unused (R. 564, 570).

On December 16, 1959, the Commission gave notice of the filing of SCG's application in its Investment Company Act Release No. 2948. The Commission therein ordered SCG to mail a copy of the release to each of its preferred stockholders not later than December 18, 1959, and provided an opportunity for hearing to interested persons who might make a request for a hearing on or before December 28, 1959 (App. 18, 21).[2] This release was also published in the December 19, 1959, Federal Register, 24 Fed. Reg. 10319, in compliance with Section 40 of the Act and Rule O–5 thereunder. The record shows petitioner knew that SCG's application was pending before the Commission prior to the Commission's approval order of December 30, 1959, but that petitioner did not request a hearing (R. 1382–1383).[3] No need having been shown for a hearing, and

[2] Petitioner's statements (Pet. 6) that "[i]n fact, no common stockholder received notice until after the transaction was consummated," and (Pet. 22) that "[t]he public common stockholders never had a chance to * * * participate in any trial on the merits of the transactions * * *" approved by the December 30, 1959, order are undocumented.

[3] See 17 C.F.R. 270.0–5(c).

there being no outstanding request therefor,[4] none was held.

The Commission on December 30, 1959, issued an order granting the application. It found with respect to Section 17(b) that the proposed acquisition of the Anemostat stock by DCA was "consistent with the policy of SCG and with the general purposes of the Act and that the terms of the proposed transaction, including the consideration to be paid are reasonable and fair and do not involve overreaching on the part of any person concerned" (Pet. App. 37). With respect to Section 23(c)(3), the Commission found that the proposed purchase by SCG of its preferred stock "would be made in a manner or on a basis which does not unfairly discriminate against any holders of the preferred stocks" (*ibid.*). The transaction was consummated the next day.[5]

By letter of March 29, 1960, to the Commission, petitioner asserted that SCG's application had "misrepresented the facts and was a fraud on the Com-

[4] A request for hearing by letter, dated December 23, 1959, had been received by the Commission from a preferred stockholder of SCG, but this request had subsequently been withdrawn by telegram (R. 60–62, 64, 65).

[5] SCG held its regular annual stockholders' meeting on April 13, 1960. At this meeting a majority of the shares were voted to ratify the sale of the Anemostat stock as well as all acts taken by the officers and directors during 1959 and to the date of the meeting. The majority also voted to reelect the directors who had been elected at the November 11, 1959, directors' meeting. These directors then voted to ratify all acts taken by the officers and directors during 1959 and to the date of the meeting.

mission," that because of a violation of Section 16 (a) the filing of the application had not been legally authorized, and that as a result the Commission's exemption order of December 30, 1959, was void. Petitioner requested "advice as to the views of the Commission on the status of the aforesaid order, and whether or not there is any necessity for action on the part of Mr. Nadler to procure the official recognition of its invalidity" (R. 85–86).

The Commission instituted a private investigation on April 1, 1960 (R. 1374), and thereafter on April 12, 1960 (App. 12), ordered a public hearing to determine whether its exemption order of December 30, 1959, should be revoked. Petitioner, SCG, DCA, and the Division of Corporate Regulation of the Commission participated in extensive hearings[6] before a trial examiner, *inter alia*, as to the reasonableness and fairness of the transactions (R. 960–1050, 1140–1242). Briefs were filed and oral argument was heard before the Commission. On December 23, 1960, the Commission determined not to revoke its prior order.[7]

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[6] The hearing record filled some 1500 pages, 897 devoted to testimony of witnesses and the remainder to documentary exhibits (R. 362–1272, 1371–1952).

[7] On April 1, 1960, petitioner had instituted an action in the federal district court against SCG, its directors and DCA to set aside the stock transactions. When the Commission announced public hearings on the matter, the district court issued a temporary injunction preserving the status quo and staying the court proceedings. All parties, including petitioner, consented (Pet. 7). Upon issuance of the Commission's order of December 23, 1960, petitioner entered a stipulation providing for dismissal of his court action should the Commission's order be upheld by the court of appeals (Pet. 9).

It ruled (Pet. App. 42) that "the defect in the election of the board of directors makes our order voidable but does not make it void." Its opinion noted that before approving the Anemostat transaction, it had scrutinized the facts and found that the terms were "reasonable and fair and did not involve overreaching"; that "examination of the record in the instant proceedings indicates that no * * * showing has been made" "that material facts were withheld * * * or that there was fraud in other respects in the submission of the application for exemption"; and that had it originally been aware of the non-compliance with Section 16(a), it would not have reached "a different conclusion" (Pet. App. 44–45).[*] The Commission noted further "that the failure to comply with Section 16(a) was inadvertent; that since the purchasers of the SCG stock from DCA were the major beneficial owners of SCG they could have elected, and at the next regular meeting of stockholders did elect, their representatives as directors in compliance with the requirements of Section 16(a) * * *" (Pet. App. 48–49).

The court of appeals, in a *per curiam* opinion affirming the December 23, 1960, order, held that the Commission's findings "are supported by the evidence, [and] are crucial against the petitioner's claim" (Pet. App. 29).

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[*] The Commission also noted that it had been aware from the regularly filed ownership reports that the Anemostat transaction was entered into on behalf of SCG by persons who had just acquired their shares of SCG stock from DCA and had just become directors (Pet. App. 45).

ARGUMENT

This case presents no important issue warranting review. It involves only the question whether, in the particular factual circumstances here shown, the Commission was justified in refusing to revoke an order granting an exemption from certain provisions of the Investment Company Act of 1940. The court of appeals correctly upheld the Commission's refusal to revoke.

1. Petitioner contends that the Commission was required to revoke its prior approval of the Anemostat transaction upon receipt of notice of the non-compliance with Section 16(a). The contention finds no support in the terms of Section 16(a), which provide that "No person shall serve as a director * * * unless elected * * * at an annual or special meeting duly called for that purpose * * *," that "vacancies occurring between such meetings may be filled" without a meeting, provided two-thirds of the directors "shall have been elected * * * at such annual or special meeting * * *," and that in the event the number of regularly elected directors shall fall below a majority, a meeting for election of directors shall be held within sixty days "unless the Commission shall by order extend such period." Neither this section nor any other provision of the statute provides that all acts of a board whose members were inadvertently elected in violation of Section 16(a) are void or that Commission approval of an otherwise proper applica-

tion must be automatically rescinded when such noncompliance is brought to its attention.[9]

Under the facts of this particular case, the Commission was clearly justified in exercising its discretion not to revoke the exemption order of December 30, 1959, approving the Anemostat transaction. The Commission found (see *supra*, p. 8): the infraction was inadvertent; except for the defect in the election, the authorization of the application and the subsequent consummation of the transaction were legal and within the authority and power of the board; no material facts had been withheld at the time of the original application; and there was no fraud in other respects in the submission (Pet. App. 42–45). The Commission noted further that the provisions of Section 16(a) were designed particularly to prevent *seriatim* resignations and elections of directors "where the result is to deprive the beneficial owners of any voice in the conduct of the management, [and] where the insiders who arrange a shift in control do not own the requisite amount of voting shares necessary to effect a change in management at an annual or special meeting"[10] and that this condition

[9] Petitioner's contention that, under Section 47(b) of the Act, the transaction was rendered void is without merit. That section provides in pertinent part that every contract made in violation of any provision of the Act, and every contract whose performance involves such violation or the continuance of any relationship or practice in violation of the Act, shall be void. It relates only to contracts whose provisions in themselves, or whose performance, involve violations of other sections of the Act. Cf. *Graham-Newman Corp.*, 28 S.E.C. 133.

[10] Pet. App. 44 and n. 15; see Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, Part 3, p. 1878 (1940).

did not exist in the instant case, since the controlling group in SCG had a majority of the common stock of that corporation.

2. The Commission's action was consistent with the regulatory scheme established by Congress which wrote broad exemptive powers into the Investment Company Act. Thus, Section 6(c) specifically provides that the Commission:

> by rules and regulations upon its own motion, or by order upon application, conditionally or unconditionally to exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

It has been held that Section 6(c) authorizes the Commission to grant a retroactive exemption.[11] Here the Commission indicated that had it been aware of the non-compliance with Section 16(a) at the time it originally acted upon the application, the exemption

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[11] *Hennessey v. Securities and Exchange Commission*, 293 F. 2d 48, 50 (C.A. 3).

In a recent case the Commission was requested to grant and granted such retroactive exemption from several sections of the Act, including Section 16(a). See *In the Matter of Townsend Corp. of America, Townsend Management Co.*, Investment Company Act Releases No. 3288, 26 Fed. Reg. 6404 (July 1961) and No. 3296 (SEC File No. 812-1415).

order would nevertheless have been granted and that its refusal to revoke that order was consistent with the "public interest" and "the protection of investors"—the standards for an exemption under Section 6(c).

3. In view of the fact that petitioner (1) invited the Commission to recognize the invalidity of its order of December 30, 1959 (R. 85–86), (2) consented to a stay of his district court action against SCG, its directors and DCA pending the results of the Commission's hearing proceeding (Pet. 7), and (3) stipulated in the district court that he would dismiss that action upon affirmance of the Commission's order by the court of appeals (Pet. 24), his contention that he has been deprived of his day in court by reason of the Commission's action in declining to revoke its prior order is without merit. These facts also dispose of petitioner's contention (Pet. 11, 20–22) that the court of appeals' decision is in conflict with *Brown* v. *Bullock*, 294 F. 2d 415 (C.A. 2), *Brouk* v. *Managed Funds, Inc.*, 286 F. 2d 901 (C.A. 8), certiorari granted, 366 U.S. 958, or *Goldstein* v. *Groesbeck*, 142 F. 2d 422 (C.A. 2), certiorari denied, 323 U.S. 737. Those cases deal with implied rights of action under the Investment Company Act of 1940 (*Brown* and *Brouk*) and the Public Utility Holding Company Act of 1935 (*Goldstein*). This issue could only have been raised as a defense to petitioner's district court action and was foreclosed by his voluntary dismissal and decision to litigate the matter before the Commission.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

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Supreme Court of the United States

October Term 1961

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SECURITIES AND EXCHANGE COMMISSION, ET AL.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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The SEC cannot pass this case off as involving merely a routine affirmance by the Court of Appeals of an administrative order of the Commission. The proceedings and order of the SEC on which the Court below relied were a nullity insofar as any binding effect on petitioner or that Court was concerned.

The real question presented by this case is whether the SEC can block a public investor's right to have a violation of the Act tried by the courts and prevent an independent judicial determination of the legality of an order granted by it in error.

This case starts with an admitted and flagrant violation of Section 16(a) of the Act, when an entire board of directors was put in office by the illegal and outlawed device of *seriatim* resignations. Their first act was to loot and cripple the investment company by turning over half its assets to those who put them in office.

As soon as these facts were discovered a suit was brought in the District Court by a public investor to enforce the violation of the Act and void the illegal transaction.

Unfortunately, the SEC had been an unwitting participant in the illegal scheme by permitting the disqualified directors to jam through the SEC, without a hearing, and on nine days constructive notice by second class mail during the Christmas holidays, an exemption of the transaction from other prohibitions of the Act.

The SEC staff should have caught the violation of the Act but by error didn't. Had it known of the violation, or that the transaction was not at arms-length, the Commission would never have granted its order on an *ex parte* presentation and without notice to, and an opportunity to be heard by, the common stockholders.

But with the mistake uncovered and a suit pending in the District Court, the SEC did not join in that suit or await a judicial determination of the violation of the Act by the forum vested with exclusive jurisdiction of the matter.

Instead, the SEC usurped the jurisdiction and function of the District Court and, on its own motion, instituted its own proceeding to try the identical questions there pending. The record of that proceeding reveals an astounding attempt to justify at all costs the SEC's mistake. The trial examiner repeatedly held that the original order could not be attacked by the public investors unless they first proved actual fraud in obtaining the order in addition to the violation of the Act. The Commission adopted that same position in its Findings and Opinion (Pet. App. 45, 46, 47).

This absurd and unfounded legal pronouncement, placing an impossible burden of proof on the outside public investor as against the law-breaking fiduciary, effectively blocked the presentation or consideration of any case by the public stockholders.

The SEC then discontinued its proceedings. They had served the purpose of permitting the SEC to review the legality of its own order and try the violation of the Act before the questions could be tried by a court of competent jurisdiction. Unless those proceedings were a nullity, they would bar the suit in the District Court under the doctrine of *res adjudicata* or they would be binding on the Court as an administrative determination

In view of the strategy pursued by the SEC, petitioner had no choice but to ask the Court of Appeals to declare the SEC proceedings a nullity and not binding on him. Petitioner at the same time, in order to remove the illegal exemption order as a bar to the District Court suit, asked the Court of Appeals to enjoin or set aside the SEC's original order as procured by the invalid acts of illegal directors which petitioner had elected to void.

Instead of making an independent judicial determination of the legal questions raised by petitioner, the Court of Appeals affirmed the SEC order discontinuing its proceedings and held the Commission's Findings and Opinion to be conclusive against petitioner. In effect, the Court of

Appeals held that the public investor has no right to have the courts pass on the legality of an SEC order or try a violation of the Act, if the SEC does not acquiesce.

A basic question presented to this Court is whether the Court of Appeals erred in the legal status and effect it ascribed to the SEC proceeding.

The SEC proceedings were a nullity insofar as having any binding effect on petitioner or the Court of Appeals. The SEC order was merely an exercise of its executive discretion not to prosecute and as such could not be affirmed by the Court of Appeals. It was not an act of judicial discretion because the SEC is completely without jurisdiction to try a violation of the Act.

1. *Reply To The Argument That The SEC Had Discretion.* The claim that the SEC has discretion with respect to a violation of the Act has a deceptively valid ring to it. It falls apart completely once the obvious and necessary distinction is made between executive-discretion and judicial-discretion.

Nobody disputes that the SEC has executive-discretion to decide for itself what action it will take on an alleged violation of the Act. It can go into court to enforce it, or refrain from doing so on any grounds it sees fit, including the belief that no violation exists. These are the familiar prerogatives of any prosecutor or enforcement agency.

But such executive-discretionary decisions are binding on no one except the SEC. In *Goldstein v. Groesbeck*, 142 F. 2d 422 (2 Cir., 1944) cert. denied 323 U. S. 737, it was held that an agreement made by the SEC not to enforce a violation of the Public Utility Holding Company Act of 1935 did not bar a suit under the Act by a private stockholder on the same violation.

By discontinuing the proceedings which it had itself initiated to look into the matter, the SEC did no more than exercise its executive discretion to take no action on a violation which it deemed excusable. Such an order because it is so clearly an exercise of executive discretion is not binding as an administrative-judicial determination or

even reviewable by the courts as such. It is clearly comparable to the Commission's order in *SEC* v. *Louisiana Public Service Comm.*, 353 U. S. 368, where under the Public Utility Holding Company Act the SEC by order declined to reopen a prior proceeding. This Court there held that type of order not subject to judicial review by the Court of Appeals.

2. *Reply To The Argument That The SEC Had Jurisdiction.* It is elementary that a court or administrative body must have jurisdiction in order to make its decree or order binding on third parties.

The SEC has absolutely no power or jurisdiction to try a violation of the Act, to make a binding determination of whether or not there was a violation, its effect if any, or to enforce it. That jurisdiction is exclusively vested in the courts by Section 44 of the Act (Pet. App. 62).

Unlike other Acts administered by the SEC, Congress in the Investment Company Act of 1940 gave the SEC no power of administrative-judicial enforcement. The only enforcement of the Act is through the courts. The SEC under this Act cannot in an administrative-judicial hearing find a violation of the Act and issue a stop order or a cease and desist order, which would be given the effect of an administrative determination by the courts. The SEC must go into the courts as a litigant alleging a violation of the Act, and that issue is tried independently by the courts. Under the legislative scheme of this Act, the SEC's role is limited to the granting of exemptions from the Act.

The SEC had no jurisdiction to try a violation of the Act without a proceeding for an exemption order. Its attempted usurpation of the jurisdiction and function of the District Court was not binding on petitioner and the Court of Appeals erred in making the SEC proceeding conclusive as to petitioner's rights.

3. *Reply To The Argument That The SEC "In Effect" Granted A Retroactive Exemption Order From The Violation Of Section 16(a).* Realizing that the SEC has no jurisdiction to try a violation of the Act, and that its statu-

tory power is limited to the granting of exemptions, the argument is now made that the SEC "in effect" granted a retroactive exemption or that its action was "consistent" with that power.

The short answer to this proposition is that no SEC order exempting the violation of Section 16(a) exists or was ever granted. The speculation that the Commission might have done so is fully disposed of by the fact that it did not.

Not only was no such order in fact granted, but the SEC in its brief to the Court of Appeals thrice expressly denied that it had made such an order directly or by implication.

> "Petitioner erroneously believes that the Commission, in deciding not to revoke the prior order, has granted an exemption from Section 16(a)." (SEC Brief to Ct. App. p. 16)
>
> "An examination of the facts makes it apparent that an exemption was not granted." (SEC Brief to Ct. App. p. 17)
>
> "Consequently, the determination not to revoke the prior order was based on these considerations and not because of an exemption from Section 16(a) granted by the Commission." (SEC Brief to Ct. App. p. 17)

Moreover, Section 6(c) of the Act (SEC Brief p. 11), upon which reliance is placed for this power of the SEC to grant an exemption order, permits the SEC to grant exemptions on its own motion only by general rules and regulations. To grant a specific exemption by order, Section 6(c) requires that an application be made to the Commission. Other requisites of such an order are notice of the application to the interested parties, a hearing on the merits, an order granting the exemption and finally an opportunity for an appeal therefrom to the courts. Not one of these prerequisites exist in this case.

Petitioner cannot be deprived of his rights under the Act and his day in court by a non-existent exemption order.

4. *Reply To The Argument That The Illegal Acts Of The Directors Are Not Void But Only Voidable Under Section 16(a) Of The Act.* "Void" or "voidable" is an exercise in semantics and makes no particle of difference in this case. Even a void act stands as valid until someone elects to void it.

All parties before this Court agree that the illegal acts were at least voidable. The real question in the case is "Who could elect to void them?"

The Court of Appeals held that only the SEC could elect to void the illegal acts. Petitioner contends that a public stockholder has an equal and independent right to elect to void the illegal acts. This is the heart of the question presented to this Court.

A public stockholder, for whose benefit the Act was enacted, had elected to void the illegal acts and brought a suit in the District Court to do so before,—we repeat, before—any action was taken by the SEC on the violation of Section 16(a).

The Court of Appeals erred in not holding the illegal acts voidable at the election of a public stockholder, and in refusing to make an independent judicial determination of the legal questions presented by petitioner.

5. *Reply To The Argument That The Stipulation In The District Court Bars Petitioner From Relief.* The action in the District Court is still pending and has not been dismissed. The injunction of that Court preserving the status quo is still in effect.

Contrary to the statement on page 12 of the SEC brief, petitioner did not stipulate to the dismissal of the District Court action if the Court of Appeals affirmed the SEC order. The stipulation is effective only upon the final disposition of this case and that will not be until this Court has spoken.

The stipulation is totally irrelevant to the issues here presented. It was entered into in good faith recognizing that the same legal questions were presented by the petition to the Court of Appeals as were presented in the

District Court action. The Court of Appeals will not pass on the same case twice and its declaration of the law is binding on the United States District Court for the Southern District of New York.

It is the decision of the Court of Appeals that will bar any further action in the District Court, not the stipulation. The truth and validity of that contention can readily be tested by reading the Court of Appeals' opinion and then considering whether petitioner could prevail in a District Court action on the same violation, absent any stipulation.

6. *Reply To Certain Misstatements Of The Record.*

a) The SEC brief at page 4 makes the statement that reports had been filed by the new owners. While reports were filed by the three new directors, no reports were filed by the other purchasers since the stock had been split up in such a way as to give each holder less than 10% of the class and thereby circumvent the reporting requirements of the Act. For instance, the fact that the wife of the Executive Vice-President of Dynamics was one of the purchasers under her maiden name was a well kept secret until the last days of the hearing.

b) The SEC brief at page 5 states that petitioner knew of the original application before the order was issued but did not request a hearing. The fact is that petitioner in New York heard a rumor that there was such an application on December 28th, the same day that time to request a hearing expired in Washington, D. C. at 2 P. M. Petitioner promptly applied to Dynamics and SCG for information but first received any concrete knowledge of the proceeding when he was shown a copy of the SEC order on December 31st, the day the transaction was consummated (Pet. App. 40; Rec. in Ct. App. 1379-1386).

c) The SEC brief at pages 7 and 12 refers to the fact that petitioner brought the violation of the Act to the attention of the SEC and invited it to take action. The SEC fails to add that this invitation was not accepted.

It was only when petitioner advised the SEC that he intended to bring the District Court action, and after he did so on April 1, 1960, that the SEC took action to initiate its own proceeding on April 12, 1960.

d) The SEC states at page 7 of its brief that petitioner had a full hearing on the reasonableness and fairness of the transactions. The record of the proceeding before the trial examiner and the SEC's own Findings and Opinion belie this conclusively (Pet. App. 45-47). The SEC repeatedly stated that it would not and did not reconsider the fairness and reasonableness of the transactions, since in its view petitioner first had to prove actual fraud in addition to a violation of the Act. The Commission went so far as to deny a motion of its own staff to take additional evidence on the merits because it believed it irrelevant under its decision (Pet. App. 49). The length of the hearing or the record has little meaning if petitioner's evidence is excluded from consideration.

e). The SEC states at page 12 of its brief that petitioner consented to a stay of the District Court action pending the hearing by the Commission and seeks to interpret that as an agreement to litigate the matter before the Commission. The consent to the stay was no such agreement. The SEC fails to state that on the hearing petitioner promptly and vigorously objected to a trial of the violation by the SEC and its usurpation of the jurisdiction and function of the District Court (Rec. in Ct. App. 363-422; 436-438; 513; 529). The trial examiner overruled petitioner's objections, which were renewed by petitioner in his brief and argument and again overruled by the Commission. Moreover, the SEC seems to forget that lack of jurisdiction cannot be cured by consent.

CONCLUSION

Brook v. *Managed Funds, Inc.*, 286 F. 2d 901 (8 Cir., 1961), certiorari granted, 366 U. S. 958, presented the question of whether a public stockholder has any independent rights under the Act. This case presents the same question with the equally important added question of whether the public stockholder can be deprived of those rights by the SEC.

For the foregoing reasons, certiorari should be granted to review the decree of the Court below.

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